THE EXCHANGE RATE

Why too strong a pound has caused deindustrialisation, trade deficits, too much borrowing and too little investment, low and unstable economic growth, stagnant wages and too many people losing out from globalisation.

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THE EXCHANGE RATE

THE UK'S ACHILLES HEEL

Introduction

Is there an underlying reason why so many of the problems faced by the Western World since about 1970 have all become so much more acute? Why have slow growth, high unemployment, low levels of investment, deindustrialisation and increasing inequality all become more apparent, at least compared to what had been achieved between 1945 and 1970? Clearly, something fundamental has gone wrong and the fact that so many of the difficulties now faced in the Western World all started to manifest themselves at about the same time in so many different countries suggests that there may well be an underlying link between them. This pamphlet sets out what the cause of our diminished performance might be, while recognising that at least some of what needs to be done to improve matters will go against the grain of much of the received wisdom among our politicians, the commentariat, the academic world, the civil service and public opinion, all of whom have long been conditioned to think otherwise.

Clearly, there is a big problem. For the first quarter of a century after the end of World War II, economies in the West grew by an average of over 4% per annum, compared to no more than 1.5% recently[1]. Unemployment in Western Europe averaged barely 2% between 1945 and 1970 while since then the reported rate has hovered round 10%, although the actual rate has generally been about 50% higher than this when all those who are caught in benefit traps, who have been designated as long term sick or have given up hope are included[2]. Inequality both between regions and sociological groups has become much wider as Gini coefficients, which measure inequality, demonstrate all too vividly. In much of Europe the relevant

figures switched from being in the mid-20s to the mid-30s in recent years[3]. Happiness remains a relatively elusive concept but the evidence which is available strongly suggests that contentment with people's lot peaked at about 1970 and has not increased since even though Western economies are considerably larger now than they were then. GDP per head has risen across the West by about 125% over the 45 years between 1970 and 2015[4]. It is not surprising, against this background, to find that politics has become more fragmented as support for traditional major parties has withered, voting in elections has gone down, and single issue and protest parties have become more prominent. It is self-evident that the power and influence of the West has declined hugely in relation to the East over the same period.

What is the link between all these developments? This pamphlet argues that the most important common factor between them all is that the West has allowed itself to become deeply uncompetitive with the East – primarily by mismanaging its exchange rates. Of course, on its own, this cannot account for all the trends highlighted above. Many other important influences have had a bearing on what has happened, but this does not stop exchange rate misalignments having had a much greater impact than is generally recognised and being the underlying *causa causans* for much else that has gone wrong. The analysis which follows explains why this has been the case, pointing to what might still be done to arrest and to reverse the trends which have hit the West so adversely in recent decades.

The Exchange Rate

The exchange rate for any country is crucially important because this is what regulates and determines its commercial and financial relationships and its ability to compete in the world. If it is too high, exports – particularly manufactures – will languish and import penetration will increase. Because, for all developed and diversified economies, manufactured goods account for the majority of their foreign trade[5], the competitiveness of their prices is critically important, especially for production processes which are not significantly protected by intellectual property

rights and specialist knowledge. Production of this type will inevitably gravitate towards where the cost base is lowest.

The cost base consists of all the inputs to production costs which are paid in the domestic currency – sterling in the case of the UK, the dollar in the USA and the euro in much of the European Union (EU). Typically, about one third of the costs of manufacturing operations consists of raw materials, components and plant and machinery, for which there are world prices, while two thirds of the costs are locally incurred[6]. These charges, which make up the cost base, consist of everything from wages and salaries to bus and train fares, from audit charges to cleaning costs, from bank and interest charges to business rates and other taxes.

Any country's competitiveness depends on the rate at which the cost base is charged out to the rest of the world, and this is almost entirely an exchange rate issue. Some simple calculations show the magnitudes involved. If country A has an exchange rate which is 30% above where it should be to be averagely competitive, as a first approximation it will have to try to sell its goods abroad at 2/3 x 30% – i.e. 20% – above average world prices. By contrast, country B, whose exchange rate is 30% below the level required for it to be averagely competitive, will be able to sell its goods abroad for 20% below average world prices. The aggregate difference in export price levels between them would be 40%. It is not difficult to see that country A will steadily lose share of world trade to country B.

This is exactly what has happened to most countries in the Western World compared to those in the East. Taking the UK as an example, in 1950 our share of world trade was 10.7%. By 1980 it had fallen to 5.7% and by 2015 it had halved again to 2.9%[7]. By contrast, China, which as late as 1980 only had less than a 1.0% share of world trade, had, by 2015, seen this ratio rise to 14.1%[8]. The consequence of changes in share of world trade on this scale is that, for a variety of closely related reasons, the UK economy grew much more slowly than China's. A combination of lack of profitable opportunities and fiscal constraint has meant that UK total gross investment as a percentage of GDP has fallen to 13% (excluding investment in intellectual property)[9], with only just over a quarter going to manufacturing[10],

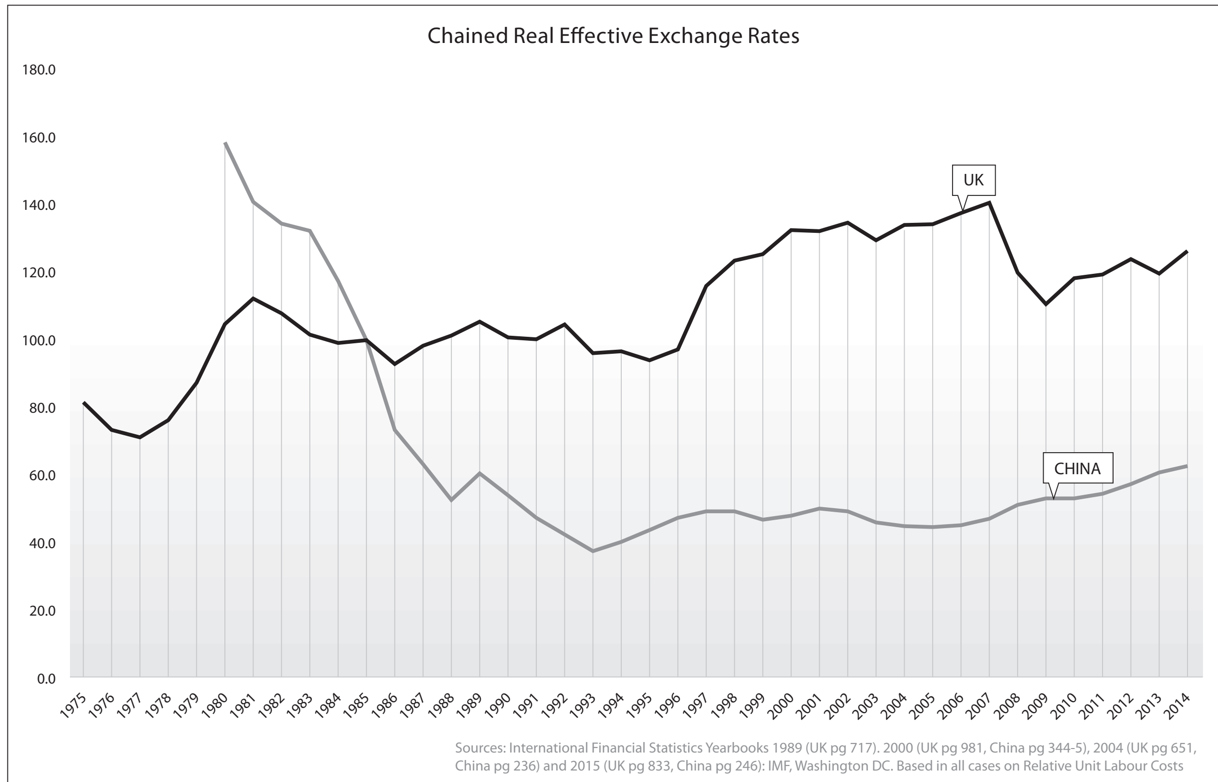
while China's has risen to 46%[11], of which almost one third – about 15% of total GDP compared to barely 3% in the UK – is devoted to manufacturing, which has the greatest potential for generating increases in output per head among the labour force[12]. Constant balance of payments deficits in the UK's case – with no surplus having been achieved in any year since 1985[13] – made it more difficult to run the economy at full steam ahead than in China's case, where there were huge foreign trade surpluses every year[14].

Poor prospects in manufacturing have had important secondary effects. Low profitability and uncertain expectations mean that few of the most able people in the UK have chosen careers in industry rather than the professions or banking or the media, increasing the difficulties of competing successfully in already hostile conditions. Lack of opportunities for profitable investment have discouraged funding for industrial expansion. Political power and influence has drifted away from manufacturing towards the City. The result has been that the UK has deindustrialised to a point where the country now suffers from a balance of payments deficit in goods which is now running at a level of about £125bn per annum[15]. As late as 1970, 32% of UK GDP came from manufacturing. Now it is barely 10%[16].

Overall, the impact of the loss of competitiveness of Western economies compared with those sited beside those along the Pacific Rim has been that the West as a whole – shorthand here for North America and Europe – has lost share of world trade and has consequently grown much more slowly that the most dynamic countries in the East – China, South Korea, Malaysia, Thailand, Hong Kong, Singapore and Taiwan. Between 1980 and 2015, the share of Western economies in world trade dropped from 65% to 59%, while that of the Eastern countries rose from 8% to 21%[17]. Over the same period, GDP per head, as a proxy for living standards, rose by about 200% in the West and by well over 20 times in China[18].

The massive discrepancy between these figures is very largely explained by the huge difference there has been between the exchange rate and competitiveness experience of the East and the West. The graph below shows just how far the cost base in the

East has gone down in relation to that in the West, using the UK and China as proxies for all the other countries involved with broadly the same experience.



Between 1977 and 1981, the UK's real exchange rate against all other currencies rose by almost 60%. After roughly plateauing for the next decade and a half, allowing for a drop in 1992 as we left the Exchange Rate Mechanism (ERM), it started another steep rise in the late 1990s, plateauing again at an even higher level during the first decade of the 21st century. It fell about 25% between 2007 and 2009 but has since crept back up before falling rather more than 10% after the EU referendum vote. By contrast, during the first ten years after China returned to the world economy around 1980, the Chinese both devalued the yuan and became more efficient as a result of the impact of market reforms. The result was that the rate at which the Chinese cost base was charged out to the rest of the world fell dramatically and China's real effective exchange rate fell by about 75%. The very large difference in the costs of producing almost everything in China compared to in the UK explains all too clearly why the outcomes in the two countries have been so different.

Economic Growth

Why is the exchange rate – and whether it is set at a competitive level or not – so crucially important as a determinant of how fast any economy is likely to grow? It is because the vast majority of economic growth comes from very narrow sectors of the economy – essentially, and, to a very large extent, only – manufacturing and technology, as the spreadsheet on the next page shows. It is the exchange rate which very largely determines whether there will be high or low levels of investment in these crucial areas.

Increases in GDP per head only began to materialise on any scale when the Industrial Revolution began, initially in the UK, in the late eighteenth century. These rises in productivity only happened because of the invention of machinery and the technology which was associated with it. All the rest of the economy benefited hugely from the increases in output per head which were achieved by machinery and technology and of course the economy progressively adapted to the enormous changes in total output which the Industrial Revolution made possible. The key to the massive rise in living standards which came about was investment in labour-saving equipment of all kinds.

By contrast, most investment in roads, schools, hospitals, railways, office buildings, and housing, however important it is from a social perspective, has never done much to increase GDP. The returns on investment of this kind to the economy as a whole is usually barely more than the interest charges which have to be paid on the money to finance them. Investment in manufacturing and technology is different. Here, given the right conditions, the returns to everyone in the economy – often called the social as opposed to the private rate of return – are much, much higher. If a machine which makes one unit is replaced by one that makes two from the same inputs, productivity doubles. If a van replaces a wheelbarrow or a tractor is used for ploughing instead of a horse, the gain is even greater. The benefit is then spread around in higher wages, bigger profits, more tax payments and better products.

Changes in Output per Head of the UK Working Population between 1997 and 2015

	1997	Gross Value Added in constant £bn	Labour Force in '000s	Gross Value Added per Head £'000s	% GVA in 1997	% GVA in 2015	1997-2015 Change in GDP % Output
A	**Agriculture**	9.1	484	18,787	0.8	0.7	-0.1
B	**Mining and Quarrying**	66.1	70	944,500	5.8	1.9	-3.9
C	**Manufacturing**	160.0	4,251	37,632	13.9	9.7	-4.3
D	**Electricity, Gas, etc**	17.6	118	148,907	1.5	1.2	-0.3
E	**Water**	13.7	131	104,412	1.2	1.2	0.0
F	**Construction**	81.3	1,757	46,255	7.1	6.1	-1.0
G	**Wholesale Retail & Motor Trade**	134.3	4,628	29,023	11.7	11.6	-0.1
H	**Transportation and Storage**	58.4	1,265	46,169	5.1	4.4	-0.7
I	**Accommodation and Food**	28.6	1,646	17,395	2.5	2.7	0.2
J	**Information and Comms**	37.5	1,039	36,080	3.3	6.3	3.0
K	**Financial & Insurance**	72.9	1,112	65,544	6.4	6.9	0.5
L	**Real Estate**	112.7	276	408,504	9.8	11.7	1.8
M	**Professional Science Tech**	50.7	1,628	31,128	4.4	8.0	3.5
N	**Administration & Support**	34.7	1,600	21,699	3.0	5.2	2.2
O-Q	**Government, Health and Edu**	219.2	6,483	33,808	19.1	18.1	-1.0
R-U	**Other Services**	50.8	1,356	37,458	4.4	4.2	-0.2
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		1,147.5	27,844	41,213	100.0	100.0	0.0

	2015	Gross Value Added in constant £bn	Labour Force in '000s	Gross Value Added per Head £'000s	Output per Head Percentage Changes from 1997 to 2015: Total % Change	Output per Head Percentage Changes from 1997 to 2015: Annual Average	Weighted Average % of the Economy	Growth Contri-bution %	% Growth Contri-bution %
A	**Agriculture**	11.7	384	30,568	62.7	2.74	0.8	0.4	2.0
B	**Mining and Quarrying**	30.6	76	403,211	-57.3	-2.55	3.5	-1.7	-8.5
C	**Manufacturing**	155.0	2,614	59,300	57.6	2.56	11.4	5.7	27.9
D	**Electricity, Gas, etc**	19.9	139	143,295	-3.8	-0.20	1.4	0.0	-0.2
E	**Water**	19.5	180	108,261	3.7	0.20	1.2	0.0	0.2
F	**Construction**	98.3	2,118	46,416	0.3	0.02	6.5	0.0	0.1
G	**Wholesale Retail & Motor Trade**	186.2	4,965	37,510	29.2	1.43	11.6	2.9	14.4
H	**Transportation and Storage**	70.7	1,387	50,978	10.4	0.55	4.7	0.4	2.1
I	**Accommodation and Food**	43.2	2,174	19,888	14.3	0.74	2.6	0.3	1.6
J	**Information and Comms**	101.4	1,344	75,449	109.1	4.18	5.0	4.7	23.3
K	**Financial & Insurance**	110.7	1,131	97,868	49.3	2.25	6.7	2.8	13.9
L	**Real Estate**	187.3	501	373,780	-8.5	0.46	10.9	-0.8	-3.9
M	**Professional Science Tech**	127.9	2,569	49,771	59.9	2.64	6.5	3.3	16.4
N	**Administration & Support**	83.7	2,692	31,108	43.4	2.02	4.3	1.6	7.9
O-Q	**Government, Health and Edu**	291.2	8,342	34,909	3.3	0.18	18.5	0.5	2.6
R-U	**Other Services**	68.2	1,782	38,250	2.1	0.12	4.3	0.1	0.4
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		£1,605.6	32,398	49,559	20.3	1.03	100.0	20.3	100.0

Sources: ONS Tables on Employees by Standard Industrial Classification (SIC) ONS reference LPROD02. Gross Vlue Added by SIC from ONS Table referece GDP (O) Low. ONS include a qualification that some of the date provided is volatile and that users are therefore requested to tke this into account.

How big can the social rate of return be? In the right circumstances it can be enormous – much higher than the rate of interest and over 100% per annum at peak, as experience across the world shows. Even including investment in assets with low rates of return, the average return on all investment was 44% in the UK during the mid-1930s, after the 1931 devaluation[19]. Between 1941 and 1944 in the USA, private investment averaged a staggering 250%, as the US economy concentrated resources on gearing up for more and more war production[20]. In Japan during the whole of the 1950s and 1960s it averaged 35%[21]. Across the world as a whole, during the period of strong growth after World War II, it averaged as much as 25%, peaking at 30% in 1964[22].

The key to a fast rate of economic growth, therefore, is to ensure that there is as much investment as possible in manufacturing and technology so that, net of depreciation, there is a rapid a build-up of productive assets. For this to happen, two key conditions have to be fulfilled. One is that making the necessary investments has to be profitable and the second is that there has to be a large volume of demand for the output which can then be produced. The way for these conditions to be fulfilled – at least in peace-time – is for there to be a competitive enough exchange rate to provide the profitability, combined with access to world markets to generate an ever-expanding volume of sales. This is the formula which provided the high growth rates seen in all the successful economies throughout the world – Western Europe in the 1950s and 1960s, Japan over the same period and until about 1980, the Tiger Economies – South Korea, Taiwan, Hong Kong and Singapore – for a much longer period, and especially China since the 1980s.

The reason why the UK – and much of the West – has done so badly recently is that these conditions have not been fulfilled. The exchange rate has been – and is – too high, especially compared to those in the Far East, either to make investment in manufacturing and technology worthwhile on anything like the scale required or to provide the demand from abroad to achieve large volumes of sales. Instead, investment as a percentage GDP has fallen; most of the investment that is undertaken has gone into other sectors than manufacturing and technology; and the ratio between depreciation and new investment has become so high that our total

stock of productive assets has almost stopped growing. With our rapidly rising population it is now – per head – very definitely falling. The result is practically no increases in productivity, little or no growth, stagnant GDP per head, balance of payments problems, rising debt, deflation and relative if not absolute national decline. This is what we have achieved in the UK by allowing our exchange rate to be far too high for far too long.

The cost has indeed been huge in relation to what might have been achieved if better policies had been in place. If we ran our economy more competitively, it would not be difficult to get our growth rate up on a sustainable basis to 4% or even 5% per annum[23] – a rate regularly achieved by Singapore, for example, where the standard of living is considerably higher than it is in the UK. Between 2004 and 2014, the average cumulative rate of growth of the Singaporean economy was 6.1% per annum[24]. In 2015, GDP per head in Singapore was $52,889 compared to $43,734 for the UK. On a Purchasing Power Parity basis, the discrepancy was even more in Singapore's favour – $85,209 to $41,325[25]. If Singapore can achieve this kind of performance, why cannot we do the same? We could and we should.

Unemployment and Underemployment

The disbenefits flowing from an over-valued exchange rate do not just have implications for the overall growth rate, important though these are. They also have major distributional effects, tending to affect strongly adversely those who for one reason or another are disadvantaged much more harshly than those who are better placed. These impacts are felt most crucially in the job market.

During the twenty-five years following World War II, there was almost no unemployment in Europe at all. The average ratio between those out of work and the total labour force hovered round 2%[26]. Since the 1970s, the situation has radically altered. The average headline unemployment the in the UK has been about 6%. In the EU's Eurozone, the position has been much worse. As of the middle of

2016, the unemployment rate was 4.9% in the USA, 5.4% in the UK and 10.2% in the Eurozone[27].

These figures need to be set in the context of labour forces which have changed dramatically in character, mostly because of much higher female participation in the labour market than was the case before. This is why the proportion of those aged between 16 and 65 who are in work has risen so dramatically and why the proportion of the total population between the ages of 16 and 65 who are working has gone up. In the UK it is now 78.4% compared with 74.5% in the mid-1980s[28].

This increased labour force participation should not, however, be allowed to obscure the fact that there are still nowadays large numbers of people who would like to work but who have no job. There is also ample evidence that the headline unemployment rate significantly underestimates the total number of people who would be willing to work if they could do so for a reasonable wage but who are not currently looking for a job because they are caught in benefit traps, they have been signed off as long-term sick or because they have given up hope of finding a job. When all these people are added in, the true level of involuntary unemployment rises by about 50%[29]. The reason why the unemployment rate nowadays is as high as it is found to be is that there is still too little demand for labour in relation to its supply, and this too is largely – although not entirely – an exchange rate issue.

The reason for this is that, with limitations on the rate at which demand on the economy can be expanded, mainly as a result of balance of payments constraints, the demand for labour has not for a long time been high enough to provide work for everyone who would like to work. This then leaves a large section of the labour force competing for jobs at low wage levels, which in turn discourages labour saving investment and depresses investment. Successive governments in the UK have struggled with this problem by subsidising low wages through tax credits, only to see the cost of these programmes rising from £4bn in 1999 to £28bn by 2015[30], as it has proved more and more difficult to make them effective as productivity among a large section of the labour force has, at best, remained static, while often actually falling.

Inequality

There is also a particularly exchange rate-related reason why inequality of incomes in the labour force has steadily become more pronounced over recent decades. Most, although not all, cost components for internationally traded goods are wage-related in the sense that they are ultimately made of wages and salaries. The issue then is at what rate those wages and salaries can be charged out to the rest of the world at a level which is competitive with those available elsewhere. The answer is that those who are highly educated and who have special skills are, relatively speaking, in a much stronger position to do so than those who lack these accomplishments. This is one of the major reasons why the UK does well on international trade in services, with a trade surplus in 2015 of £89bn, and so badly on goods, where we had a deficit in the same year of £125bn[31]. What we therefore find is that, across the world, countries with very high exchange rates have much more of their economies involved in services and less in manufacturing, because in these circumstances it is relatively easier to prosper in services and more difficult to do so in industry. The result, however, is constantly to widen out the income differentials between those at the top and bottom end of the income scales.

Another way of highlighting the same tendency is to point to another crucial divide – thrown into sharp relief by the results of the June 2016 EU referendum – which is between those who have done well out of globalisation, internationalism, migration and the UK's membership of the EU generally and those who felt that these factors had done little for them, while upsetting their lifestyles and undermining their earning capacities. It was those doing well in the top end of the service sector, especially in London and some other major cities, who overwhelmingly voted for Remain and those in our erstwhile industrial heartlands on insecure and poorly paid jobs who voted Leave. The international market for services is less price sensitive than it is for manufacturers, partly because comparisons between what is on offer are more difficult, while the UK has definite comparative advantages in services because of its language, geographical location, legal system and experience, and because of the talent of the labour force which has been attracted to providing them. None of this applies to manufacturing where, especially for medium- and

low-tech internationally tradeable activity, competitiveness is crucially important. This is why an exchange rate which works reasonably satisfactorily for services can still be lethally too high for manufacturing.

And the differences between those who are prospering and those who are not are enormous and tending to grow all the time, although the 2008 crash took its toll on high earners, especially in financial services, thus temporarily at least slowing down the trend. Over a longer perspective, however, the Gini coefficient figures tell a daunting story. In the mid-1970s, the Gini coefficient – a commonly used measure of inequality where the higher the number the greater the inequality – in the UK was 0.23. It is now 0.34[32]. The disparity between CEOs and shop floor workers has widened dramatically and continues to do so – up from 160 times that of the average UK full-time worker in 2010 to 183 times in 2014, with FTSE CEOs pay averaging £4.96m that year[33]. No wonder there is so much resentment to be found among those for whom incomes on this scale are well beyond the dreams of avarice.

Debt

Over the last few years there has been an explosion in the amount of debt created across nearly all of the world. The monetary base in the UK had risen by 2015 to 10.4 times its size in 2004 while GDP increased over the same period by no more than 19.5%. In the USA the equivalent figures are 5.6 and 23.1%. It is not, however, just in the West that these sorts of developments can be found. China too saw its monetary base rising between 2004 and 2015 by 5.2% while its GDP rose by 198% – albeit that the ratio between debt creation and real GDP was substantially lower in China than in the US and especially the UK[34].

Debt is not necessarily a problem. Credit has oiled the wheels of commerce and government for thousands of years. Debt becomes a major hazard, however, when debtors begin to suspect that their creditors will not be able to meet their obligations. The problem faced by the world in 2016 is that this condition may be looming

not just on an individual but on a systemic scale in at least three areas. First, private sector debt – held by non-financial corporations and households – may be getting too great for comfort. Second, bank debt – held by banks both in the public and private sectors – may be getting too high for risks of default on a major scale to be ignored. Third, if banks default on a wide enough scale, governments which provide the backstop to the provision of credit required to keep the world economy functioning may find that they are no longer in a position to supply the support needed to avoid collapse occurring.

Debt held by the non-financial sector and by households has increased over the last decade and a half but not by that much. It rose strongly, especially in the West, running up to 2008, followed by a period deleveraging from which there has been a rebound recently. There are therefore some signs of consumers getting overstretched. The amount of household borrowing in the UK, for example, partly driven by the very high cost of housing, is now rising quite sharply. Overall, however, the situation looks manageable. The corporate sector has been accumulating cash balances for a long time and is, as a whole, very solvent.

The situation with banks is much more problematic, and here the major problem is the Eurozone. Banks within the Eurozone are already in a weak position because of the large proportion of non-performing loans they have on their books, reported in the autumn of 2015 as being just under 4% of their total compared with 2% in the USA[35], but much greater in some countries where the non-performing loan rate is reported to be as high as 18% in Italy and 13% in Portugal[36]. For many years Germany and Holland have been running huge balance of payments surpluses – both 8% of GDP in 2015[37] – mostly with the other Eurozone Member States. These surpluses have been financed by bank loans involving the creation of vast amounts of debt which, it is increasingly clear, is never going to be repaid. As long as the EU's Single Currency does not break up, this situation may be sustainable but if significant economies in the system – Spain and Italy in particular – drop out of it, and then devalue by a large amount, the scale of defaults would be very large, potentially making banks insolvent not only individually but on a systemic basis.

Keeping the credit system on which the world depends operating would then fall back onto sovereign states.

It is not just the Eurozone which is potentially capable of destabilising the world's banking and financial system. There are also threats from China, the Ukraine and elsewhere, where again bank failures on a major scale would have to entail sovereign state bail-outs. Economies which have their own central banks cannot go bankrupt as they can always create enough money to meet their obligations, although the side effects may be very painful. These are certain to entail some mixture of the potentially inflationary effects of very large increases in the money supply and the accumulation of very large additional government debt as the state provides the capital required to bring the banking system back to solvency. The crisis which developments of this kind would precipitate would be very likely to plunge the world into the same sort of deflationary and growth-destroying spiral which happened around 2008, quite possibly on an even larger scale.

What has caused the world financial system to become so much more unstable in recent years? The answer is that very largely it has been a combination of globalisation and misaligned exchange rates. The Eurozone is the extreme example of an inappropriate exchange rate regime institutionalising imbalances, but the record of the West in allowing its economies to become grievously uncompetitive with those in the East, particularly China, has generated trading and financial imbalances on an even larger scale. Between 2004 and 2015, China's cumulative balance of payments surplus was $2,800bn while the US's deficit was $5,380 and the UK's $996bn[38]. The UK, it will be recalled, has not had a balance of payments surplus since 1985[39].

The effect of balance of payments deficit is to suck demand out of the economy, which has to be replaced elsewhere both as a matter of fact and accounting logic. During the run up to the 2008 crisis, this was done by the authorities both strongly encouraging private sector borrowing and by governments running deficits and thus also acting as large-scale borrowers. During the years immediately following the crash, however, as can be clearly seen from the table below, illustrating what

happened in the UK, the private sector strongly deleveraged with the corporate sector hoarding cash and the household sector paying off debt. This left the government effectively in the residual role of holding up demand by running large deficits.

UK Net Lending (+) and Net Borrowing (-) by Sector. All figures are in £m

Year	Public Sector	Corporations	Households	Foreign Balance	Net Totals
2004	-41.7	58.0	-39.8	23.6	0
2005	-40.3	61.8	-45.9	24.4	0
2006	-35.0	51.5	-54.6	38.1	0
2007	-38.4	75.2	-66.4	29.6	0
2008	-76.8	35.0	-12.9	54.8	0
2009	-160.5	65.5	50.6	44.4	0
2010	-150.4	36.3	71.1	43.1	0
2011	-124.6	53.4	41.7	29.5	0
2012	-139.4	41.7	36.2	61.6	0
2013	-99.5	19.0	3.6	76.9	0
2014	-101.7	16.0	0.3	85.4	0
2015	-80.6	-6.0	-10.9	101.4	3.9
2016 Q1	-16.5	-7.9	-4.4	-32.4	3.7

Source: *Table I. Net Lending by Sector in ONS Statistical Bulletin – Quarterly National Accounts 2016 Q1 and previous editions of the same table. Figures for 2015 and 2016 are still being reconciled by ONS and the net totals will also be very close to zero when this process is complete.*

As the UK's balance of payments gap has widened from about £40bn a year up to 2011 to close to £100bn by 2015, the government deficit has had to continue to

take much of the strain even though households and the corporate sector are now borrowing more, thus taking some of the strain off the government deficit. The problem which the UK now has – shared by most other major Western economies – is that a combination of slow growth and large deficits means that, as a ratio to GDP, government debt is on an ever-rising trend because the rate at which government debt is accumulating is considerably larger than the rate at which the economy is growing. As long as this continues, total government debt as a percentage of GDP will go on rising and interest charges as a percentage of GDP will tend to increase.

A number of consequences flow from these figures. One is that policies to reduce the government deficit to zero while the foreign payments balance remains around £100bn per annum have no chance of success unless there are unimaginable increases in both consumer and corporate borrowing. Given that this is the case, it might make more sense for the government to take advantage of current very low interest rates to undertake much more capital investment, even if this pushed up total government debt. As of 2015, interest charges on UK government debt were running at 2.3% of GDP[40] – a much lower percentage than was the case between the wars, for example, when between 1920 and 1938 they averaged 5.8%, peaking at 7.1% in 1926[41].

There is, however, a substantial likelihood that anti-austerity policies along these lines will cause the foreign payments balance to become even more strongly negative than it already is. The only real solution is to eliminate the root of the problem and to get the balance of payments back under control – and at the same time to stop the country as well as the government getting further into debt. If we run a foreign payments deficit of £100bn a year which – as we do – we finance by selling assets or borrowing with a gross return of about 5%, other things being equal our foreign payment balance will deteriorate by about £5bn a year. This is clearly an increasingly unsustainable path.

The conclusion is clear. If we are going to get our economy onto a sustainable basis, we will have to ensure that we have an exchange rate which stops both our government and the country as a whole drifting further and further into unmanageable debt.

Happiness

There is still, nevertheless, a nagging question as to whether trying to improve economic performance is a worthy objective at all, even supposing that the problems involved in making this possible could be overcome. Is it the case that more output – at least beyond a minimum level, which is well below what prevails on average in most of the Western World – does not improve happiness and therefore is a goal which it is pointless to pursue? There is now a significant literature which shows that, on the vast majority of measures which can be used, most people do not seem to be much, if any, happier now than they were decades ago when their living standards were substantially lower[42]. There are complex reasons for this state of affairs, with incomes relative to other people playing a substantially larger role than the absolute levels involved. It may well be the case, furthermore, that if living standards go on rising, if other things remain equal, the same results will generally go on being found. Even if this turns out to be true – which seems likely – there are very important exceptions to the happiness thesis which suggest strongly that better performance by the developed world would still improve rather than have little influence on the human happiness condition.

First, being unemployed involuntarily is one of the major causes of unhappiness, and so is job insecurity[43]. If this is the case, running the economy with much lower levels of unemployment must improve the happiness quotient. Indeed, this may be perhaps the most important way in which economic performance can increase happiness because so many of the other factors which affect people's attitude to life – such as family relationships, community and friends, health, personal freedom and personal values – are not really related closely to levels of income at all[44].

Second, if the major contribution which the economic world can make to human happiness is to provide satisfying work, there is great danger in allowing conditions of little or no growth to materialise, especially over a long period. This is because there is no reason to believe that these conditions would stop productivity continuing to rising by something of the order of 2% per annum, at least among the more favoured sections of the workforce – as it has done ever since the Industrial

Revolution started – even if there is no overall growth. If this happens, and the same amount of output can be produced by fewer and fewer people, unemployment – or underemployment in low-paid, insecure jobs – is bound to go up – exactly as has happened across the Western World. This is why there are good reasons for believing that poor economic performance is very likely to reduce happiness, however measured.

Third, while happiness may not increase with living standards once a reasonable minimum level has been achieved, there are large numbers of people in the world whose income per head is far below this point. It is one thing not to feel more content with life when your income goes up but when you nevertheless always have enough to eat, when you do not suffer from a disease for which remedies exist but for which you cannot afford to pay, and when you have somewhere tolerable to live. It is quite another to eke out life in severe poverty. Both within Western societies and among the Third World, which depends heavily on the West for economic support, there are very large numbers of people whose condition very obviously would be improved by higher living standards.

Fourth, while it may well be true that having more and more material goods does not make people happier, there can be little doubt that most people still have an urge to buy more goods and services than they did before, given the opportunity to do so. Frustrating their capacity to do so may not have the dire effects on their individual personal well-being that they might anticipate, but it may well have collective disadvantages if a sense of overall failure and degeneration overcomes the whole of the society in which they live.

Those who claim that increasing living standards beyond a certain point does not generally increase human happiness may well be right, but this is not an argument against making sure that economic policy contributes to contentment where it can.

Objections

This pamphlet argues that the only way to rebalance the UK economy and to get it into a position where it is capable of sustained growth, combined with both as close to full employment as we can get and with an acceptably low level of inflation, is to get the parity of sterling down to a level which makes a number of objectives possible to achieve. We need to get the proportion of our GDP which we invest rather than consume up to at least 20% from its present 13%. We have to get manufacturing as a percentage of our GDP up from its current 10% to around 15%, without which we will never be able to pay our way in the world. We need to get our overall balance of payments under control with the annual deficit as a percentage of GDP no greater than our growth rate, so that at least we are not sliding further and further into debt in relation to our capacity to service and ultimately repay it. This is also the only way in which we will be able to get the government deficit down to the same sort of manageable proportion. In addition, we need to ensure that future growth does not depend on unsustainable increases in consumer spending but is driven much more by investment and net trade. It is also essential that the benefits of globalisation, in terms of secure prospects and good jobs, especially those provided by manufacturing, are widely enough dispersed throughout the economy to make most people, if not everyone, feel that they are beneficiaries rather than losers from the liberalisation and growth of world trade.

Many people, however, even if they were persuaded by the logic of this case, would be inclined to shy away from trying to implement it because of deeply-held suspicions that such a policy would neither be achievable nor would it work even if it could be put into practice. There are six main arguments which are regularly advanced to support these contentions. They are first that devaluation always produces extra inflation which negates any gains in competitiveness; second that devaluation is impossible to combine with an open economy; third that, if we did devalue, we would be bound to be met by retaliation which would undermine its benefit; fourth that reducing sterling's parity would make us all poorer; fifth that we have tried devaluation in the past and it does not work; and sixth that the UK is no good at manufacturing and that our economy would not therefore respond

positively to a lower exchange rate. None of these allegations 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 insofar as it applies to goods and services which are imported. Price rises here are inevitable and a necessary part of switching demand from international to domestic suppliers. It does not, however, follow that the price level generally will rise more quickly than it would have done without a devaluation and a wealth of evidence from the dozens of devaluations which have occurred among relatively rich and diversified economies such as ours in recent decades shows that in fact lower parities sometimes produce a little more inflation, sometimes a bit less, but most of the time little if any change. This may seem a very surprising result to many people but this is what the statistics show. Looking at recent examples, when the UK left the Exchange Rate Mechanism in 1992, sterling fell by a nominal trade weighted 12%[45], but inflation fell from 5.9% in 1991 to 1.6% in 1993[46]. 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[47], and what increase there was in 2011 was very largely driven by an increase in commodity prices, which fell away as soon as these prices fell back again[48]. The reason why these are common outcomes is that, while higher import prices push up the price level, many factors to do with a lower parity tend to bring it down. Market interest rates tend to be lower, and so do tax rates. Production runs become longer, bringing down average costs. Investment, especially in the most productive parts of the economy, tends to rise sharply, increasing output per head, reducing costs and producing a wage climate more conducive to keeping income increases in line with productivity growth. Furthermore, as domestic supplies of goods and services become more competitive with those from abroad, demand switches to domestic sources, negating the need to pay higher import prices even if foreign suppliers reduce their prices to try to retain market share.

For all these reasons, the plain fact is that neither theory nor historical experience, based on a wide range of individual cases, show evidence of devaluations having

any systematic effect on increasing inflation above what it would have been anyway. Still less does either theory or practice show that competitive gains from a devaluation tend rapidly to be eroded by higher inflation, although this is a central tenet of monetarism, which perhaps explains why so many people believe it to be the case even though it is not true. On the contrary, the longer-term evidence very firmly indicates that economies which have strongly competitive international pricing tend to do better and better as highly productive investment is attracted to those sectors of the economy most likely to produce productivity increases 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[49] 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 to fall against the yen by 51% between 1985 and 1987[50].

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

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 increasing deficit by selling assets has kept the markets confident that the rate at which sterling is trading on the foreign exchanges is sustainable. It is far from clear that this confidence will continue indefinitely for two main reasons. One is that the UK may soon have sold so many assets that it will be increasingly difficult to find enough to sell in future, especially if more safeguards relating to the sale of UK assets are put in place, thus making it more difficult to keep the exchange rate as high as it is at the moment. The second is that every £100bn annual deficit, financed by selling assets with an average gross return of the order of 5%, adds another £5bn 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"[51]. It may, therefore, very well be the case that in the foreseeable future there will be a change in market sentiment which will bring sterling down to a lower parity with or without the assistance of the authorities.

Retaliation If the UK were to devalue by a sufficient amount – probably about 25% from its current level (October 2016) – to enable the economy to reindustrialise to a point where we could pay our way in the world – is it likely that there would be retaliation from other countries which would negate any benefits in the form of increased competitiveness which the devaluation had secured? The answer to this question needs to come in several parts.

In the first place, it depends on the position from which the devaluing country starts. The curse of foreign payment imbalances starts not with countries like the UK, with massive deficits, but with economies such as Germany, Switzerland and the Netherlands, which ave huge surpluses – currently almost 8% of GDP in Germany's and the Netherlands' cases, and 15% for Switzerland[52]. These surpluses have to be matched by deficits somewhere else in the world economy. Unfortunately, surplus countries are never under any immediate pressure to reduce the beggar-thy-neighbour impact of their surpluses by revaluing their currencies, and this leaves economies such as ours, carrying big deficits, with no alternative but devaluation

to get the situation under control. There is thus a very strong principled case for countries such as the UK to make for getting sterling to a more competitive level.

In terms of practicalities, the UK has a number of advantages which other countries do not share. We are not in the EU's Single Currency, membership of which would clearly preclude the UK from doing anything about its exchange rate. We still have our own central bank and control over our own interest rate and monetary policy. Sterling is not a world reserve currency like the dollar, making it much easier for us to alter our exchange rate without there being major international consequences. The fact that our share of world trade is now so low – at 2.9% in 2015[53] – 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%[54] – and the fall in the rate for sterling against the dollar between 2007 and 2009 – about 25%[55] – both engendered no retaliation. Both were evidently seen by other countries – the markets and the authorities – as being exchange rate adjustments which were clearly warranted by the state of the UK economy. Against the background of our currently ballooning foreign exchange deficit, there is no reason why the same could not be made to happen again.

Sterling and Living Standards It is frequently argued that a devaluation must make us all poorer and this argument tends to take two forms, neither of which are correct.

The first is that if we reduced the value of the pound by, say, 25%, in world currency terms, we would make ourselves 25% worse off and we would therefore genuinely be poorer by this amount. The fallacy with this argument is that, while it might well be well founded if we did all our shopping in international currencies such as dollars, this is not what UK residents do except perhaps when they go on holiday. UK citizens pay for almost everything they buy in sterling and it is therefore GDP measured in sterling, not in dollars, which counts. This is the way in which international accounting is done and this explains why IMF figures do not generally show

falls in GDP when countries devalue. On the contrary, they almost invariably show the growth rate rising and GDP increasing in consequence. Since living standards closely approximate to GDP per head, especially over time, if the economy is increasing in size and the population does not change from what it would have been anyway, GDP per head and thus living standards must, as a matter of logic, go up rather than down.

The second potentially more substantial argument is that if we are going to increase our net trade balance to a point where we are not enjoying a standard of living far beyond what we are earning – as we are at the moment – living standards will have to suffer. Relatively speaking, this has to be correct. If we produce more for export, there will be less for the home market. Furthermore, if, to get the economy to grow faster, we have to spend a considerably higher proportion of our GDP than we do at the moment on investment, there will again have to be a corresponding reduction in consumption as a percentage of GDP. The crucial question then is whether the economy can be made to grow fast enough to enable both the shift towards exports and investment to be accommodated without living standards falling – and indeed preferably rising. Careful calculations show that this would be possible – provided that a high enough proportion of increased investment goes to the most productive parts of the economy, mostly manufacturing. It can be done[56].

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

As these other countries have invested more heavily in the future than we have, their output per head has grown more rapidly than ours, their wage climates have

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%[57]. It was against this kind of background that from time to time the over-valuation of sterling would became so obvious that either the markets or the authorities or both tolerated, engineered or encouraged the parity for sterling to fall. The fall, by about 30% in 1931 – after near stagnation during the 1920s – enabled the UK economy to have its fastest spurt of growth ever during the middle of the 1930s – 4.4% per annum cumulatively for the four years between 1933 and 1937[58].

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[59]. Much 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[60]. Once currencies started to fluctuate against each other in the 1970s, following the break-up of the Bretton Woods fixed parity system in 1971[61], high inflation combined with high interest rates kept sterling much too strong, especially as the UK entered the Exchange Rate Mechanism at the end of the 1980s, followed by leaving it in 1992, with a devaluation of about 12% against all currencies[62]. After showing some signs of recovery, the UK economy then became more and more unbalanced as asset sales on a scale unparalleled anywhere else pushed sterling up to absurdly high levels in the 2000s. Its value fell between 2007 and 2009 – still by not nearly enough – since when it has climbed back a bit and then fallen at least temporarily post the EU referendum. Meanwhile, in the East, over past decades, exactly the opposite policies were followed as they massively devalued.

The reality is that the UK's exchange rate has been much too strong to allow our industrial base to flourish for most of the last two centuries. The devaluations that have taken place have made the situation rather better than it otherwise would have been, but they have almost always been too little and too late.

Devaluation and the UK 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 carried out recently, one by academics and another by the IMF[63], show that the so-called elasticities are easily in the right territory, especially after allowing a relatively short period of time – two to three years at most – for the effects to work their way through.

The reason why the UK has allowed manufacturing as a percentage of its GDP to fall from about one third in 1970 to barely 10% now is obvious. Nearly all our internationally traded low- and medium-tech manufacturing has been driven out

of business and there is insufficient high-tech activity – also subject to long term threat – to fill the gap. We cannot allow this condition to continue.

Politics and Liberal Values

Finally, there is another vital link to be made between exchange rate policies and the likely future direction of our economic and political environment, especially regarding conserving and enhancing liberal democratic values generally. While in much of the West trust in both the political system and politicians appears to be eroding away, in much of the more authoritarian and decidedly less democratic East there is much more confidence in the way their countries and their economies are run, and belief that their future prospects will be good. There is thus a very real risk that a key implication of sustained low growth and stagnant incomes may be that Western liberal democracy will be undermined and perhaps eclipsed by the relative success of regimes which are much less tolerant and open than those which we very easily take for granted.

For liberal democracy to be sustained, there has to be a reasonable amount of trust between those in power and those who are governed. It is not difficult to see that this trust has diminished substantially in recent years and that it is still on the slide. Much of the reason for this development has to do with the failure of Western governments, particularly since the 2008 crisis, to get the economy working well enough to raise median incomes. When the crisis hit in 2008, most people turned to their established political leadership for solutions. Eight years later, with almost none of those responsible for the 2008 cataclysm having been brought to account, with bankers still enjoying immunity and with most of the population still paying with stagnant wages and salaries for what went wrong, patience is running low.

It is hardly surprising, in these circumstances, that new political parties have gained strength based on rejection of the rationalism which is, at bottom, the bedrock of both moderate left and moderate right political parties. UKIP in the UK, the

Trump phenomenon in the USA, the Front National in France, Podemos in Spain, Alternativ für Deutschland in Germany, and Syriza in Greece are all part of the same phenomenon – a rejection of traditional politics which their adherents believe – with considerable justification – no longer serves their interests. The problem with all these parties is that many of their policies and objectives are in conflict with each other and are unachievable. Frustrated by awkward reality, it is all too easy then for protest parties like them to fall back on visions of the future, often embracing protectionism, racism and xenophobia, which shade into irrationality and intolerance, and potentially even violence. Despite these deficiencies, it is not difficult to see how such parties might easily become large enough electoral forces to hold the balance, if not to be in a majority position, in several countries in the West, not excluding the UK.

By far the surest way to make sure that these developments do not materialise, and that liberal democracy and moderate centre left and right parties survive and prosper, is for us to run our economies better. We have to get our economy to grow faster so that living standards rise. We have to deal with the unsustainable imbalances which make our future growth prospects so problematic. We have to make sure that there is hope everywhere in the country and not just in favoured areas. For the sake of all our futures, we have to make the changes in policy which will allow all these things to happen.

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Since the break-up of the Bretton Woods international financial system in 1971, the UK has had a floating rate for sterling, but for almost all of the last 45 years we have had no policy as to what this rate should be. This is extraordinary. The exchange rate is the key commercial and financial link between the UK and every other county in the world. To have no view as to what the exchange rate should be makes no sense at all.

In fact, by ignoring it, we have allowed untrammelled market forces to push it to far too high a level over a long period. This largely explains why the UK economy has floundered into pitifully low levels of investment, deindustrialisation, trade deficits, balance of payment problems, rising debt, unbalanced and unsustainable growth, stagnant incomes and huge disparities in wealth, income and life chances between those who have benefited from globalisation and those who have lost out to it.

If Labour is ever to win elections again, it has to have an economic policy which both takes account of the country's competitiveness and the need for a reasonable balance between manufacturing and every other sector of the UK economy.

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