WHY TRUMP WON

What happens when globalisation benefits only the rich

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Introduction

Against all the odds, Donald Trump won the 2016 US presidential election. Something new, important and disturbing has very clearly been happening recently right across the West, with ominous implications especially for the political establishment. In addition to the astounding recent election outcome in the USA – very largely unexpected by those who thought they were in the know either side of the Atlantic – not long ago UKIP won more votes than any other party in the 2014 UK election to the European Parliament. More recently, the result of the June 2016 EU referendum in the UK was clearly substantially a vote against the establishment. In France, the *Front Nationale* is very likely to do well enough in the French presidential elections in 2017 for Marine Le Pen to be in the final ballot. In Germany *Alternativ für Deutschland* surprised Angela Merkel by beating her party's CDU candidate in September 2016 in her own home state. In Spain, in December 2015, *Podemos* won 69 seats out of 350 in the Spanish general election. In Greece, *Syriza* has since January 2015 been the largest party in the Greek parliament. In Italy, in June 2016, the *Five Star Movemen*t won control of Rome and Turin[1].

There are evidently overlapping reasons for these developments, although all the political movements involved are not, by any means, the same. Some are of the right and some of the left. Some have authoritarian streaks which others lack. Some are relatively liberal and outward looking while others are more orientated towards protectionism. All of them, however, share some common features. They are patriotic rather than internationalist. They all have varying concerns about immigration, reflecting the nativism – the feeling that indigenous residents ought to be given more consideration and support than immigrants – of a majority of their supporters. They all exhibit distrust and a measure of contempt for the established political systems.

Above all, supporters of all these parties feel let down by the way they have been treated economically. Nearly all of them have, at best, seen little or no increases in their living standards, some since 2008 but many – especially in the USA where the median wage is no higher in real terms now than it was in the 1970s[2] – with no improvement for much longer. Others have seen major reductions rather than just no rises. In the UK, according to a recent TUC report[3], for those in work the median wage dropped as sharply as it did in Greece – by 10.4% in each case between 2007 and 2015 – although Greek unemployment is much higher than in the UK. By contrast, those in the upper income brackets in the West have all done much better while those in the top 1% have done better still. Those still employed in the upper echelons of banking and financial services continue to earn massive sums while practically no-one has been brought to book to account for the chicanery, misjudgements and bad management which were the proximate causes of the 2008 financial crisis.

How should we explain what is happening? What has caused protest and populist parties to emerge and flourish right across the western world? Some of it has to do with social media. Some of it has to do with the increasing strains that mass migration has generated. But it is globalisation, and all that is encapsulated by it, which almost certainly has more to do with it than anything else. If a line needs to be drawn between those who are attracted to the new parties and those who are not, as good a place as any for it to be located is between those who, on the one hand, have done well out of globalisation, internationalism, increased travel and trade, rising migration and the increasing dominance of financial interests, and those, on the other hand, who have found themselves on the wrong side of the tracks.

It is no coincidence that all the protest parties referred to above were formed relatively recently. Nor should it be surprising that, as discontent has mounted, they have become more prominent. Although during the Great Moderation of the 1990s and the 2000s up to 2008, there were underlying economic trends developing which were dangerous and in the end very damaging, most people during this period experienced rising living standards and were reasonably contented. When the crisis hit in 2008, therefore, by and large people turned to their established political leaders for succour and support. It was politicians of the moderate left and moderate right – indeed the political establishment everywhere – who were regarded initially as the most likely people to find solutions to the problems then confronting everyone. Unfortunately, eight years later, those in charge have failed to deliver a substantial economic recovery to benefit everyone and patience has run out, especially among those at the wrong end of globalisation. This is why so many centrist political parties, especially those of the moderate left, are now in such decline and disarray, and why those that remain are being pulled strongly in directions with which many of their members feel unhappy.

For protest sheers very easily into populism and over-simple solutions to complicated problems. This is why trust between the governors, who have to find their way through complex and intractable reality, and the governed, who have to feel confident that their interests are being protected, is so important. Once this bond fractures, it becomes increasingly difficult to get rational decisions taken, for politicians to hold enough respect from the electors to be able to face down multiple powerful self-serving interests, and for the political process to work sufficiently well for stable and effective governments to be formed and then to provide stable administrations. The danger across large swathes of the western world at the moment is that we may be getting far too far from comfort as these conditions fail to be fulfilled.

The question is whether there is some fundamental reason why the malaise described above – globalisation hugely benefiting some groups but disadvantaging others – has spread across the West and, if so, what can be done about it. The case put forward in this pamphlet is not that there is a simple silver bullet which will cure all the West's ills. It is, however, that there are some clearly identifiable mistakes, made by western policy makers over the decades since the post-war Bretton Woods consensus broke up in 1971, which have led to the benefits of globalisation – great as in many ways they are – being much too unevenly spread, and that this is the sources of a very large proportion of the discontent which is now so manifest.

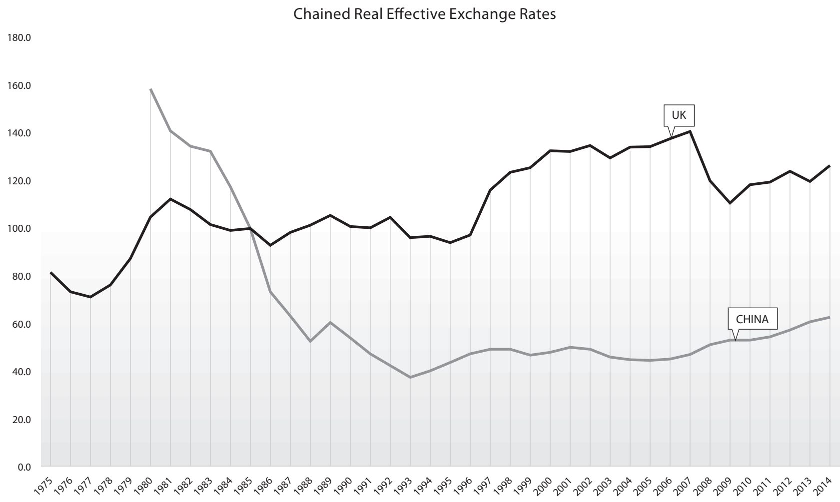
For it is not the case that the world as a whole is a much worse place than it was 45 years ago. On the contrary, in many ways it is immeasurably better. It is cleaner, healthier, better fed, longer lived and freer. Millions of people have been lifted out of poverty. The problem is that average improvements across the world have left large swathes of people, especially those on medium and low incomes in the West, little or no better off, especially recently, while almost everyone else has seen his or her lot vastly improved[4]. Identifying and avoiding some of the mistakes made since the 1970s, when the post-World War II international settlement broke up, may not on its own be a sufficient condition for improving the prospects, life chances and hope for those who have missed out on the benefits of globalisation but it is a necessary requirement for getting any real improvements in their circumstances being achieved.

And what, essentially, are the key mistakes which he West has made? Essentially they revolve round competitiveness and, in particular, the ability of the West to compete commercially with the East on reasonably level terms. The charge-sheet is that we have completely failed to do this. We have allowed the East – which, in this context, is shorthand for the countries on the Pacific Rim but particularly China – comprehensively to outflank the West – the USA, Europe and Japan – by allowing them to run their economies on far more competitive lines than ours. As a result, while we have deindustrialised, their manufacturing has gone from strength to strength. On the back of strong export-led growth, their economies have grown much faster than ours and their average standards of living have risen by a large multiple of those in the West. They invest far more than we do in the future; they are not dogged by balance of payments and government deficits rising far faster than their capacity to service or repay them; and their growth is sustainable because it is fuelled by net trade and investment and not just by ultra-low interest rates, asset inflation and consequently rising consumer demand.

It is because of these mistakes that so many of our people have done badly out of globalisation. Of course, increased international trade in services as well as goods has certainly not been disadvantageous to everyone in the West. Those in the upper ranges of the service industries, in particular, have done phenomenally well out of it and they are in a very powerful economic and political position to influence public opinion and policy development. Understandably, perhaps, they think that what has been good for them ought to be fine for everyone else – and if it isn't this is because of failure by the losers to take advantage of opportunities which they ought to have been able to grab. What these people fail to recognise is that the other side of globalisation is good manufacturing jobs disappearing in the face of unmanageable competition from the Far East, leaving a large percentage of the population dependent instead on much less productive, lower paid and less secure service sector employment. The powerful position occupied by those who have done well out of globalisation means that there is a huge amount of inertia which is inclined to keep the status quo broadly maintained in policy terms. Recent political developments in both the USA and Europe, however, suggest that time may be running out, that discontent is materialising on an unmanageable scale, and that expectations that we can go on as we are with impunity may be wide of the mark.

Competitiveness

It is one thing to say that economies in the East have done generally much better than those in the West over the last four decades; it is another to get a grip on just how enormous the gap has been. Taking the UK as broadly representative of what has happened in the West, and China as the largest example of what has been achieved in the East, between 1973 and 2014, living standards in the UK rose by 123% whereas by the end of this period they had risen in China to just over 22 times what they were at the beginning[5]. Of course, the Chinese started from a much lower base than we did in 1973 but having a high standard of living is not a bar to high growth rates. Singapore achieved an average rate of economic growth of 6.1% per annum between 2004 and 2014[6] even though the Singaporean standard of living is now much higher than ours. In 2015, average 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[7]. It was not just low wages and poor working conditions, therefore, which made China so competitive with the UK. It was something else. In fact, it was two very heavily divergent policy paths which led to the hugely different growth experience in China and the UK, and the graph below highlights what these differences were.



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

When the Bretton Woods system broke up in 1971, reckless monetary expansion, compounded by the 1973 Arab-Israeli War and OPEC oil price hikes, drove inflation upwards across most of the world on a scale which had never been seen in peacetime before. Bringing down the rate at which prices were increasing thus assumed centre stage in economic policy terms and monetarism became the fashionable way to deal with what was seen, at the time, to be the most pressing economic problem. This doctrine claimed that all that was necessary to bring inflation under control was to constrain the rate at which the money supply increased. To do this, drastic curbs were imposed and interest rates soared, with base rate peaking at 15% in the UK[8] and 20% in the USA[9]. The result was a huge rise in the international value of most of the currencies in the West. In the UK, the real effective exchange rate rose between the late 1970s and the early 1980s by nearly 60%. Whether or not such drastic policies were needed, inflation did indeed subside, although whether this was the result of monetarist policies rather than other factors is disputed. Countries such as Norway, for example, which never went in for monetarism on any scale, saw their inflation rates drop just as fast as adherents such as the UK and the USA

Whatever the results of monetarism on inflation may have been, however, there is no doubt that the effect on UK manufacturing industry of the huge reduction in its competitiveness as a result of sterling's rise was immediate and substantial. Whereas as late as 1970, manufacturing as a percentage of UK GDP stood at 32% by 1990 it had fallen to about 20%[10]. Worse, however, was to come. After a respite during the early 1990s, following the UK;'s departure from the Exchange Rate Mechanism in September 1992, and the temporary drop in sterling' value which resulted, the UK began to sell off assets on a massive scale from the late 1990s onwards, which led to a further large increase in the UK's real effective exchange rate. Some reprieve was provided by the reduction from about £1.00 = $2.00 to £1.00 = $1.50 between 2007 and 2009, but not nearly enough. Since then sterling has strengthened again, offsetting much of the benefit of the fall which took place after the EU referendum The result is that manufacturing took a further major battering as more and more medium- and low-tech industry in particular was driven out of business. Manufacturing now accounts for no more than about 10% of the UK's GDP[11].

Contrast this with what happened in China. When the Chinese began to re-join the world economy in 1980, the official rate of exchange of the yuan against the US dollar was 1.95. By 1990 it was 7.43 – a nominal devaluation of 74%. Inflation in China during this period was substantially higher than it was in the West[12], but nevertheless, allowing for this, the real effective exchange rate, taking account of both changes in the price level and productivity, fell between 1989 and 1990 from an index of 367.0 to 125.3 – a real increase in competitiveness of 66%[13].

In these circumstances, it is hardly surprising that vast swathes of UK industry have been unable to compete. What has gone is a very large proportion of all the UK's internationally tradable medium- and low-tech manufacturing. Some of what might have been lost, of course, still remains. Exceptionally efficient companies are still there. So are some businesses with specialised niches or very heavy intellectual property protection or those which have to be immediately adjacent to their customers. High-tech industries – pharmaceuticals, motor vehicles, arms, airframes and engines – have fared better, although in the long-term they may well be vulnerable as the Chinese get better at aerospace, the Koreans at car manufacturing and the Indians at pharmaceuticals. The overall picture, however, is unmistakable and very clearly visible especially outside the more prosperous areas of the UK. The UK is, to very large extent, although not completely, no longer a very serious manufacturing nation. Instead of being pre-eminent, as we once were, we have now dropped back to being no more than the eleventh largest manufacturing economy in the world[14], although this still leaves us with a substantial base from which to recover, so all is not yet lost.

Does this decline in the significance of manufacturing in the UK matter? It does – for three crucially important reasons. The first is that it is far easier to achieve productivity increases in manufacturing than it is in services, so the smaller manufacturing is as a proportion of GDP, the more slowly the economy is likely to grow. Ever since the Industrial Revolution it is very largely mechanisation and the application of technology rather than any other forms of investment, which have led to increases in output per head and these tend to be very heavily concentrated in light industry. The second is that the UK economy – like all advanced and diversified economies, – depends much more on goods than services for income from exports and, because of the relative decline of manufacturing in the UK, we do not have nearly enough to sell to the rest of the world to pay for our imports. In 2015, we had a visible trade deficit of £125bn, an overall trade deficit of £37bn[15], and a total balance of payments deficit of £96bn[16]. Nor is this just a recent problem. Ever since the trends described above began to bite we have been in deficit. We have not had a trade surplus since 1983 or an overall balance of payments surplus any year since 1985[17].

But third, and most crucially for the theme in this pamphlet, the impact of deindustrialisation has been devastating for large areas of the country and for the large number of people who have been heavily disadvantaged by seeing the manufacturing industry, on which they and their forbears depended for their good quality blue collar jobs, disappearing in front of their eyes. Replacement jobs in the service sector, especially away from the increasingly and ever more contrastingly prosperous South East, however, tended to be much worse paid, more insecure and far less satisfying. Hardly surprisingly, average incomes in our industrial heartlands are in real terms now still well below what they were a decade ago[18].

Nor are these problems acute just for individuals, serious though they are. They also apply to whole communities – to towns and cities which now do not have enough to sell to the rest of the world to pay their way, leaving them dependent on loans and grants from central government to make ends meet. Inevitably, there is not enough money to go round so the quality of public services and the infrastructure to support their communities declines as well. There are now not just pockets but large areas of the North of England where the standard of living is barely half what it is in comparable areas in the South East.

No wonder that large sections of our population are disaffected by their recent experience, disillusioned with politics as they have seen it develop in recent years, resentful at having been left behind by globalisation, and attracted by new political parties which offer them more respect and sympathy than those which previously attracted their support and which chime in much more accurately with their views of their lives and prospects. The danger is, nevertheless, that the hope which these new parties may generate will be dashed against the rocks of experience as the world turns out to be much more complicated and difficult than their supporters believe it is. This is why there may be a crucially important opportunity for the experienced social democratic left to grab, enabling it to reconnect with the supporters it has already lost, or is in danger of losing. It is to marry together its experience of government with more attractive and ambitious strategies than are in place at the moment, to produce a sufficiently appealing set of policies to enable it to start winning elections again, or, at the very least, to enable it to form an effective opposition.

Re-industrialisation

If a key objective is to get manufacturing in the UK back to a level which will provide a much better employment balance across the regions, which will enable the UK to pay its way in the world and which will generate more sustainable – as well as more inclusive – economic growth, how is this to be done? What policy steps need to be taken radically to reverse the trends which have been so manifest in recent decades towards deindustrialisation?

There is an important role that the public sector would need to play in making light industry more viable – on, for example, education and training, improving our infrastructure, ensuring that energy supplies are available, facilitating planning permissions, ensuring that there is high quality broadband and – very crucially – making sure that adequate finance is accessible. Re-industrialisation itself, however, is a process which will have to take place very largely in the private sector. Again, this does not mean that there is no role in the UK for the government, this time in increasing the proportion of GDP spent on investment which, in total, is currently pitifully low at barely 13%[19] (excluding intellectual property), compared to a world average of about 26% and nearly 50% in China[20]. The problem is that almost all the investment undertaken by the public sector – in roads, schools, hospitals, rail, etc. – has a low average rate of return to the whole economy. This social as opposed to private rate of return for most public sector investment is usually little more than the rate of interest payable on the capital used to finance it. Where really high social rates of return – often many multiples of the rate of interest, and crucial to achieving a reasonably high rate of growth for the economy as a whole – are to be found are in the application of mechanisation and technology, which pre-eminently happens in light industry, in which the public sector has never had a significant role and in which it is very unlikely to achieve success in future.

If the main vehicle for re-industrialisation has to be the private sector, however, then it has to be profitable on a wide scale for investment there to take place – and the reason why the reverse – deindustrialisation – has happened in the UK for the last few decades is that this condition has been a long way from being fulfilled for the averagely well-run company. The reason is that the cost base in the UK for manufacturing has been charged out at far above the world average, and this is why so much manufacturing activity in the UK has been wiped out.

Typically for manufacturing operations, about one third of total costs are made up by charges for machinery, raw materials and components, for which there are world prices, while the remaining two thirds consists of costs incurred in the domestic currency[21] – sterling, of course, in the case of the UK. These domestically incurred costs cover wages – typically about 15% of total costs – but also management salaries and overhead costs of all other kinds – everything from cleaning charges to travel costs, from repairs and maintenance to audit charges, and from interest charges to a provision for profit.

Now, look at the graph on page 10 to compare how, with current exchange rates, the cost base is charged out to the rest of the world in China and the UK. On average for manufacturing operations, the Chinese charge out rate, allowing for their very competitive exchange rate, has recently been barely half of the UK's. Since the post-Brexit devaluation, it has come down to perhaps two thirds, but this still leaves the UK cost being charged out at an average rate about 50% higher than China's. Suppose that total costs in China are made up of 33 for machinery, raw materials and components and 67 for all the cost base elements, making a total of 100, measured in world currency terms, such as US dollars. The comparable figures for the UK are now 33 and 67 x 1.5, which comes to 133. Since the vast majority of manufactured products have close substitutes and are therefore very price sensitive, it is hardly surprising that the UK is still losing out on world markets – and on import competition for UK produced manufactures – if it has something like a 30% price disadvantage.

There is then only one way to rectify this imbalance and this is to get the UK cost base charged out at a much more competitive level. This is essentially an exchange rate issue because it is the parity of sterling which determines the rate at which our cost base is charged out to the rest of the world. How far would sterling have to come down to be truly competitive? Not as far as might appear to be the case at first sight, because the UK does have some important factors weighing in the balance to our advantage. Sterling has already fallen almost 20% since the EU referendum vote. Further more, the UK has a very good record on exporting services, with a surplus of £89bn in 2015[22], so that we do not need to rely wholly on visible exports to pay our way in the world and to avoid the balance of payments being a constraint on growth policies. Nor do our export prices necessarily have to be as low as those from China bearing in mind that there are significant costs it getting goods from the Far East to the West. Nevertheless, careful calculations indicate that against the US dollar, the pound would have to come down to about $1.10 – perhaps a little more, to £1.00 = $1.00 – to ensure that the economic incentives were strong enough to deliver the price level we need to get manufacturing industry re-established on the scale required. It would also be absolutely essential that it was settled government policy to keep the exchange rate at its new competitive level, rather than to discourage investment in light industry by allowing it to be thought that the pound would strengthen again as soon as the government believed it could allow this to happen.

Would a strategy along these lines work? There is overwhelming evidence that it would. It is export led investment and growth which has been the hallmark of all the economies which have done well ever since the Industrial Revolution started two and a half centuries ago, but particularly since World War II. This was the formula which powered the recovery of continental Europe after 1945 and the Tiger Economies – South Korea, Taiwan, Hong Kong and Singapore – all of which started from a very low base and which have now achieved standards of living rivalling or exceeding those in the West. It was the same formula which produced such astonishingly favourable results for Japan until the mid-1980s[23] when the world choked on the Japanese trade surplus, the yen strengthened enormously and the Japanese miracle came to an end. Perhaps most strikingly of all, it is its super-competitive export sector which has enabled China to go from abject poverty to super-power status in barely more than a generation. If all these countries can achieve what they have, given the right conditions, so can we. To do so, we just need to make sure that we adopt the same policy conditions which made them so successful.

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 as close to full employment as we can get and 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. 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.

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 to repay it. This is also the only way in which we will be able to get the government annual borrowing requirement – which is largely the mirror image of the balance of payments 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.

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 is bad in itself but which may also negate 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 makes 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 so that our economy would not therefore respond very 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 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%[24], but inflation fell from 5.9% in 1991 to 1.6% in 1993[25]. 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[26], 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[27]. 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 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[28] 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 51% between 1985 and 1987[29].

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 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 sterling.

Sooner or later, the parlous state of our balance of payments is also likely to be a major factor. Up to now, the ability of the UK to finance its increasing deficit by selling assets has kept the markets confident that the rate at which sterling has been 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 much 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 about another £5bn to the underlying deficit every year. It may, therefore, very well be the case that in the foreseeable future there will be a change in market sentiment which brings sterling down to a still lower parity with or without the assistance of the authorities.

Retaliation If the UK were to devalue by a sufficient amount – probably about 15% from its current (November 2016) level – 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 with huge surpluses – currently almost 8% of GDP in Germany's and the Netherlands' cases, and 15% for Switzerland[30]. 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[31] – 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%[32] – and the fall in the rate for sterling against the dollar between 2007 and 2009 – about 25%[33] – 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. 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, neither of which is 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 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[34].

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%[35]. 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 of sterling to decline. 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[36].

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[37]. 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[38]. Once currencies started to fluctuate against each other in the 1970s, following the break-up of the Bretton Woods fixed parity system in 1971[39], rapidly rising prices 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[40]. After showing some signs of recovery, the UK economy then became more and more unbalanced as assets 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 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 hey 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 are 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 UK cost base is charged out to the rest of the world at too high a rate 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[41], 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.

Changing Course

The biggest problem is not delineating what needs to be done to get the UK economy – and those of much of the rest of the West – rebalanced, to get manufacturing industry re-established on the scale needed both to allow us to earn enough abroad to pay for our imports, to get the economy growing again and to provide much better job prospects for the large swathes of our population who have recently lost out. The challenge is to persuade enough people that policy shifts of the kind described in this pamphlet need to be achieved. The changes we need comprise a combination of what has to be done on the demand side – reformed monetary and exchange rate policies – and all the complementary changes on the supply side which need to be achieved at the same time.

For the Labour Party, however, this may be a crucial test. The problem at the moment is that the Party has no credible economic policy - although exactly the same charge can equally be laid at the door of the present Conservative government. Neither has any meaningful plans for getting the economy rebalanced. They have no policies which will get the economy re-industrialised. Their plans for investment are almost wholly focused on the public sector which, on their own, will do little or nothing to increase economic growth, for which much more investment in the private sector is the essential requirement. Neither have any policies which will reducing borrowing – indeed the reverse if a large public sector investment programme is to be undertaken, financed by increased government debt. They have no realistic plan for getting growth to come from net trade and investment instead of ever-increasing consumer demand, fed by ultra-low interest rates and asset inflation. Above all, the Labour Party in particular at present has nothing to say to the millions of its erstwhile supporters whose support it is losing very largely because it has no policies on hand to reverse the negative impact which most of these lost voters have sustained because of globalisation.

Instead, at present, all Labour can offer is a watered down version of Conservative economic policies – slightly less austerity financed by rather more borrowing. A major problem which Labour then faces is that actually, current Conservative policies, however sub-optimal they may be compared to what could be achieved, appeal quite strongly to quite large sections of the electorate who are well enough off for austerity to be a relatively minor hazard for them. The top roughly one third of the income profile in the UK is doing very well, although they could do much better if the economy was growing faster, and Labour needs to appeal to these people on this score too if it can get the economy to perform better. Where Labour is really failing at the moment is in having little appeal, with its current policies, to those who are not doing so well – to those whose earnings have not gone up in real terms and indeed may well have gone down, to those who have insecure and low paid jobs, to those whose prospects are poor and among whom hope for the future is dying. These are indeed more or less exactly the people who have suffered from globalisation rather than benefited from it. The prospect, in these circumstances, is for the Conservative vote to hold up reasonably well while the Labour vote collapses. This is the existentialist threat that the Labour Party now faces.

Of course there are problems about trying to persuade the electorate that the whole economy – but especially those at the moment least advantaged by what has been happening – would be better off if we pursued a more competitive exchange rate strategy. All the terminology round the pound is full of loaded words. If it "strengthens" or "goes up" it sounds good and "weakening" and "going down" sounds bad. Everyone likes receiving plenty of euros or dollars when they go abroad on holiday. But actually, the strength of sterling is a real class issue. A high pound is good for the City because it gives it more financial leverage; it is good for old money because it protects it; it is good for the metropolitan elite who are not in a very price sensitive environment; but it is terrible for those whose futures depend on making and selling things – and they are Labour's traditional working class supporters whose support the Party is currently haemorrhaging.

Labour therefore has a choice to make – indeed a choice shared by left of centre parties all over the West. Does the Party maintain its current economic policy stance – a pale and increasingly unconvincing version of the neoliberalism which has served working people so badly over the decades since the Keynesian post-War consensus broke up? Or does it strike out into new territory which may grate initially against the conventional wisdom but which would be capable of vastly improving the lot of the people whose interests Labour ought to be representing – while also appealing to a sufficiently large proportion of Middle England to enable Labour to start being a credible electoral force again?

Much is going to turn on the answers to these questions.

Notes and references

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Over the past few decades, international trade has increased exponentially and the world has become increasingly integrated. Many very poor people in third world countries have benefited as a result and so have the rich in the West. Unfortunately, however, large sections of the population in the western world – at least relatively to other people - have not done so. Instead, they have seen the high quality manufacturing jobs on which they and their communities depended disappearing to the Far East in the face of unmanageable price competition.

This pamphlet explains why these developments were not inevitable but were the result of policy mistakes which we now badly need to reverse, especially if Labour is ever to have an economic policy which will appeal to the millions of its erstwhile supporters it is in grave danger of losing.

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