INDUSTRIAL STRATEGY

How to make an Industrial Strategy really work

John Mills

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

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Author

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

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

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

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Introduction

Industrial Strategies in the UK have come and gone. Much in favour during the Labour government of 1964 to 1970 and even more so between 1974 and 1979, they reached their nadir under the 1979 government dominated by Margaret Thatcher, only to emerge sporadically over the following decades as the UK's manufacturing base declined relative to GDP. Now interest is back on the agenda again, exemplified by what Theresa May, the Prime Minister said recently in speeches both to the CBI and the City. She promised "a modern, ambitious Industrial Strategy which will build on the country's strengths and address the long-term structural challenges which can hold British businesses back."[1]

There are evidently a number of reasons for the revived interest in an Industrial Strategy. There is the size of our trade deficit, driven largely by the huge gap between the value of manufacturers which we sell abroad and those we buy in. Another is clearly the dissatisfaction caused by the absence of good manufacturing jobs highlighted by the June 2016 EU referendum vote. The predominance of financial services at the expense of industry, arguably producing a lop-sided economy, is a third. Underlying all these perceptions is the evident fact that, although we still have some outstanding companies and some sectoral impressive success stories, and we were once the workshop of the world, we are now, relatively speaking, only bit-players – ranking at about eleventh in the world by size of manufacturing output[2]. The issues raised in this pamphlet are whether, in light of these considerations, there really is a problem which needs to be addressed and – if there is – what should we do about it and, in particular, what should the role of government be?

The Case for Manufacturing

In 1970 just under one third of UK GDP came from manufacturing which then employed about a quarter of the country's entire labour force[3]. Nowadays, barely 10% of our GDP comes from this sector, which employs no more than 8% of our work force. To be fair, the reality of at least some of this reduction in the percentage of GDP coming from manufacturing is open to challenge for at least two separate reasons. One is that the cost of manufactured goods has tumbled over the last few decades in relation to those in services, so that the decrease in manufactures, measured in current money, is considerably less than in volume terms. Another is that the borderline between manufacturing and services has become more blurred as many companies have outsourced functions such as cleaning, so that these functions are now classified as services rather than being included in the manufacturing totals. Some manufacturing companies too have a larger and larger proportion of their revenues coming from ongoing service contracts rather than simply selling hardware. These are important factors but they do not make enough difference to alter the fact that the UK is still much less of a manufacturing economy than it was 40 years ago.

Does this matter? Yes, it does – and for three principle reasons.

The first is a reflection of the fact that the price of manufactured goods has fallen so markedly in relation to services. Productivity increases are far easier to secure in manufacturing than they are in services. Indeed, ever since the start of the Industrial Revolution 250 years ago, rising output has been driven by only quite a narrow range of economic activities – essentially, mechanisation, technology and, especially during the initial stages of the Industrial Revolution, more use of power. These are essentially the sorts of activities in which industry – and especially light industry – is pre-eminent. If a machine which makes one of something is replaced by one which makes two with the same inputs, productivity doubles. If a van replaces a wheelbarrow or a mechanical digger is employed instead of a shovel, or a crane is installed to lift goods which were previously manhandled, output per hour increases exponentially. Increases of this sort are very hard to achieve, at least

on anything like the same scale without the mechanisation, technology and power which makes them possible.

The capacity for manufacturing and those other sectors of the economy which particularly lend themselves to mechanisation and technology to provide opportunities to increase Gross Value Added (GVA) per hour and hence productivity are shown up in the tables on page 8 and 9, one covering the USA and the other the UK. Both sides of the Atlantic manufacturing produced over a long period a disproportionately large increase in GVA. Indeed, as a result, much of the increase in what is paid per hour in services, which turns up in the statistics as increased output, is in fact driven by what happens in manufacturing. If, as a result of real productivity increases as a result of mechanisation and technology, wages go up in these industries, they have to be reflected in service sector remuneration to make sure that employees are attracted to work there, even if no such increases in output can be achieved. Haircutting is the classic case. If haircuts now cost ten times in real terms what they did at the start of Industrial Revolution for the same service, in real terms there is no increase in productivity even if haircutters' GVA now shows up in GDP statistics as being ten times what it would have been in the late eighteenth century.

The second reason why manufacturing is disproportionately important for any mature and diversified economy such as ours is that our foreign earnings come mainly from selling goods rather than services abroad. Even though about 80% of our economy is services, in 2015 they only provided 44% of our export income[4]. Of the remaining 56%, about 9% is raw materials and fuel and all the remaining 47% is manufactures[5]. Our problem nowadays is that we then do not have nearly enough of them to sell to the rest of the world to pay for our imports. In 2015 we had a deficit of £120bn on goods as a whole of which £88bn was accounted for by manufactures alone[6]. Nor is this a recent development. We have not had a visible trade surplus since 1983[7].

This might not matter so much if other components of our balance of payments were in favourable shape, but unfortunately they are not. Our net income from abroad, which used to be positive at around £20bn was £26bn negative in 2015,

Changes in Output per Head of the US Working Population between 1977 and 1997

1977	Output Value in constant 1992 $bn	Labour Force in Millions	Output per Head $000s	% GVA in 1977	% GVA in 1997	1977-1997 Change in GDP % Output
Manufacturing	796.5	19.7	40.5	18.6%	18.8%	0.2%
Construction	213.8	3.9	55.5	5.0%	3.8%	-1.2%
Mining	82.4	0.8	101.4	1.9%	1.5%	-0.4%
Sub total	1,092.7	24.3	44.9	25.6%	24.1%	-1.4%
Agriculture, Forestry & Fishing	61.1	4.1	14.7	1.4%	1.8%	0.3%
Transport & Utilites	346.8	4.7	73.6	8.1%	8.9%	0.7%
Wholesale Trade	201.0	4.7	42.6	4.7%	7.3%	2.6%
Retail Trade	364.5	13.8	26.4	8.5%	9.8%	1.3%
Finance, Insurance & Real Estate	742.7	4.5	166.3	17.4%	17.7%	0.3%
Services	712.5	15.3	46.6	16.7%	19.2%	2.6%
Statistical Discrepancy	37.3			0.9%	-0.6%	-1.5%
Not Allocated	-2.4			-0.1%	-0.3%	-0.3%
Government	717.4	15.1	47.4	16.8%	12.2%	-4.6%
1977 GDP	4,273.6	86.6	49.3	100.0%	100.0%	0.0%

1997				Output per Head Percentage Changes from 1977 to 1997		Weighted Average % of the Economy	1977 - 1997 Growth Contri-bution	1977 - 1997 Growth Contri-bution %
				Total % Change	Annual % Average			
Manufacturing	1,369.9	18.7	73.4	81.4%	3.0%	18.8%	9.4%	54.2%
Construction	274.4	5.7	48.3	-13.1%	0.7%	4.2%	-0.3%	-2.0%
Mining	109.9	0.6	185.6	83.2%	3.1%	1.7%	0.9%	4.9%
	1,754.2	24.9	70.4	56.7%	2.3%	24.7%	8.6%	49.7%
Agriculture, Forestry & Fishing	127.6	2.9	44.5	201.8%	5.7%	1.6%	2.0%	11.7%
Transport & Utilites	644.3	6.4	100.8	36.9%	1.6%	8.6%	2.0%	11.2%
Wholesale Trade	532.0	6.6	80.0	88.0%	3.2%	6.3%	3.4%	19.8%
Retail Trade	713.5	22.0	32.4	22.7%	1.0%	9.3%	1.3%	7.5%
Finance, Insurance & Real Estate	1,286.0	7.1	181.4	9.1%	0.4%	17.6%	1.0%	5.7%
Services	1,398.6	36.0	38.8	-16.7%	-0.9%	18.3%	-1.9%	-10.8%
Statistical Discrepancy	-45.4					-0.1%	0.0%	0.0%
Not Allocated	-25.0					-0.2%	0.0%	0.0%
Government	884.0	19.6	45.2	-4.8%	-0.2%	13.9%	-0.4%	-2.3%
1997 GDP	7,269.8	125.6	57.9	17.3%	0.8%	100.0%	17.3%	100.0%

Source: Tables B.13, B.46 and B.100, *Economic Report to the President 1999*. Washington DC: US Government Printing Office 1999

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

Sources: ONS Tables on Employees by Standard Industrial Classification (SIC) ONS reference LPROD02. Gross Vlue Added by SIC fro 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.

as were net transfers abroad – another £25bn[8]. As a result, the total deficit was £80bn – 4.3% of our GDP[9], financed largely by the sale of capital assets on a scale unmatched by any other developed country. Indeed, it has been the impact of our huge sales of domestic assets to finance our foreign payments deficit which has been the main reason why our net income from abroad is now so large and negative.

The crucial fact about our manufactured exports is that this component of our balance of payments deficit is the only one which realistically is amenable to any influence from government action. All the other components are either constrained by other factors – such as our net income from abroad which is determined by returns on assets and our net transfer commitments, about which there is little which the government can do, at least in the short term – or they are too small and too price insensitive – to be amenable to much change. Increasing our manufactured exports is the only practical solution to getting our foreign payments deficit down to a sustainable level.

The third crucial factor about manufacturing is the quality of the employment which it is capable of providing. Manufacturing provides 10% of GDP but does so with only 8% of the country's labour force, which implies a productivity level 25% higher than the average in the economy as a whole. As manufacturing has declined and millions of manufacturing jobs have migrated elsewhere – to the Far East but also to some European countries such as Germany and Holland – the number of good quality blue collar manufacturing jobs in the UK has declined. In 1978 6.6m people were employed in manufacturing. Now the number has fallen to 2.6m[10].

This trend has had a very marked effect on what has happened to average wages over large areas of the UK. Those which depended heavily on industry have seen a marked switch towards much lower productivity, low wage and insecure jobs, often providing less pride and satisfaction too. The result has been that the median wage in the UK is still only fractionally higher than it was before the 2008 crash[11].

Nor is this a factor which just affects individuals. It has also had a major impact on whole communities, towns and cities, which no longer have enough to sell to the

rest of the world – rather like the UK economy as a whole – so that they become dependent on subsidies from the rest of the county – primarily London. Inevitably, there is then never enough money to go round, causing cuts both in capital expenditure and on revenue services, leaving many of our erstwhile proud industrial cities looking increasingly shabby at the same time as services for their citizens are cut back. The result is a huge disparity in incomes, wealth and life chances between different parts of the country. In 2013 the average GVA generated by employees in London was £40,215 whereas in the North East it was £17,381[12].

What should an Industrial Strategy achieve?

There is, therefore, a strong case to be made for the very small proportion of GDP coming from manufacturing in the UK being a sign that the UK economy is seriously unbalanced. Investment in industry is very low, reflecting lack of profitable opportunities. We have a chronic balance of payments problem which has sucked demand out of the economy as payments go abroad instead of to domestic suppliers, with the gap being filled by borrowing. This is why both as a nation, as consumers and through our government we are accumulating debt much faster than our capacity to service it or to repay it. What growth we have managed to achieve has been very largely driven by consumer demand, on the back of ultra-low interest rates, asset inflation and equity withdrawal, instead of from net trade and investment. And on top of this, we have a huge and rising inequality problem as London and the South East flourish in our liberalised, globalised and services oriented economy while most of the rest of the country faces poor employment prospects and relative poverty as the manufacturing jobs on which livelihoods used to depend have withered away.

If there is to be an Industrial Strategy worth its name, therefore, surely its aim should be to get the UK reindustrialised so that the economy is sufficiently rebalanced to ensure that it has a stable and sustainable future. It is then not too difficult to carry out some calculations to establish how large a proportion of GDP would

need to come from manufacturing for this to happen – and the answer is about 15%. This is a substantially lower percentage than in many advanced industrialised countries such as Germany where the ratio in 2015 was 23%, and 20% in Singapore, 19% in Japan and 18% in Switzerland, but higher than some other countries, such as France at 11% and the USA at 12% which also, like the UK, suffer from chronic balance of payments problems[13]. The reason why the UK does not have to achieve more than about 15% is that we have a much stronger services export sector than nearly all other countries. The UK's export surplus, at £90bn and close to 5% of GDP in 2015, is a much higher percentage than is achieved by any other comparable country[14]. Even Switzerland, with an overall balance of payments surplus of 11.4%, achieved an export surplus of no more than 2.8% of GDP[15].

Could the government run an Industrial Strategy which would get the UK reindustrialised to a point where 15% of its GDP came from manufacturing. It could, although not by pursuing the sorts of Industrial Policies that have not worked in the past. We need a new approach.

What does not work

A variety of Industrial Strategies have been tried in the past. The most ambitious was undertaken immediately post-World War II, although without clear overall benefits in terms of higher economic growth, by the Labour government which nationalised large amounts of the economy, including transport, energy, coal and steel, and was committed to taking the "commanding heights of the economy" into public ownership. The Conservative government which was in power from 1951 to 1964 did little to reverse nationalisation but did frequently intervene – via tax concessions, direct funding and government purchases – to support various industries, including aircraft construction, armaments, nuclear power, shipbuilding and even the early computer industry. Britain's relative decline and the apparent success of both MITI in Japan and the French planning system then induced the Macmillan government to set up the National Economic Development Council

(NEDC), bringing together representatives of management, trades unions and government in an attempt to reverse the UK's relative economic decline – but again with little tangible success.

The Labour government which came to power in 1964 used the NEDC framework as a building block for its National Plan, headed by George Brown, which had ambitious plans to increase output by 25% over a five-year period, using widespread intervention in the economy and an Industrial Reorganisation Corporation (IRC) to restructure much of British industry. Little came of this initiative, however, which was swamped by the sterling crisis which culminated in the 1967 devaluation.

The IRC was wound up by Edward Heath's Conservative government which came to power in 1970 determined to reduce the role of government in the economy and not to prop up any more "lame ducks". Events, however, soon blew this approach off course. In 1971 the government temporarily nationalised Rolls Royce to save it from bankruptcy and in 1972 a return to interventionism was signalled by the passing of the Industry Act which aimed to promote regional and national growth though tax incentives, development grants and other measures. This set the scene for the high-water mark of post war industrial policy orientated to controlling and managing the private sector which took place under the 1974-79 Labour government, led by Tony Benn as Secretary of State for Industry. Comprehensive Planning Agreements were proposed between large companies and the government which would commit industry to investment and job creation, in return for which it would receive financial and other benefits. A National Enterprise Board was established to provide funds for the regeneration of British industry although, at very substantial expense, very little was achieved. It has been estimated that some 95% of the funds thus deployed went into failing companies rather than those which the government hoped would provide the bedrock for the future[16].

The advent of a new Conservative government under Margaret Thatcher radically changed the culture and there was a decisive movement away from interventionism. Nationalised industries were broken up and privatised and deregulation became the watchword. Such was the strength of the consensus round this attitude that the

Labour administration which came to power in 1997 did little to change the direction of travel and the same broadly hands-off approach continued after the change of government to the Conservative/Lib Dem coalition in 2010[17]. The largest interventions followed the 2008 crash when two of the UK's largest banks, the Royal Bank of Scotland and Lloyds/HBOS were taken into public ownership.

While over the last 30 years, since the Labour government of 1984-89, large scale interventions in manufacturing industry have therefore gone very largely out of fashion, there has nevertheless been continuous involvement by government in the supply side of the economy, without taking control of privately owned companies. Large amounts of effort and money have gone into training schemes. The government has struggled with the railways, which have attracted even larger subsidies from the government than when they were publicly owned[18]. Regional Enterprise Boards have come and gone. Policies were adopted to combat Global Warming the subsidies for which have led to very large increases in energy prices. The takeover of existing companies by foreign interests, and sometimes the establishment of new ones, particularly in the car industry, has been condoned or encouraged. Little has been done, however, to tackle the underlying cause of the decline of UK manufacturing industry – particularly its low- and medium-tech internationally tradable components – leaving largely only high tech arms, aerospace, vehicles and pharmaceuticals, which have done relatively well because for various reasons they are more difficult to attack from low cost competition. Between 1970 and 1990 manufacturing as a percentage of UK GDP, fell from 32% to 20% and since then it has fallen to barely 10%.

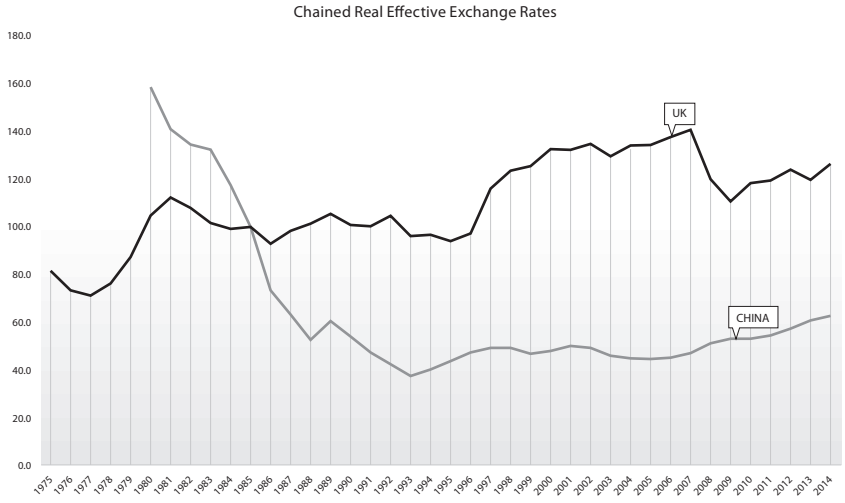
In her speeches during the autumn of 2016 about the government's new approach to Industrial Strategy, Theresa May told the CBI conference that "it is not about propping up failing industries or picking winners, but creating the conditions where winners can emerge and grow", At the Lord Mayor's Banquet she told the City that "It is a new way of thinking for government – a new approach. It is about government stepping up, not stepping back, building on our strengths, and helping Britain overcome the long-standing challenges in our economy that have held us back for too long."[19] The will to achieve results is clear there but more than general

sentiments of this sort are going to be required if UK manufacturing is going to be revived on the scale which is now needed.

Demand and Supply

Why has UK industry – and particularly medium- and low-tech industry – declined to the extent it has in the UK – and to a much greater extent than in almost any other advanced industrialised country? There is a simple explanation and it has little to do with the supply side issues which are so frequently blamed – although education and training, access to finance, improved infrastructure, more favourable investment allowances, etc., are all important and need to be part of any mix of policies which is going to be effective. The problem has been that all the Industrial Strategies which have been tried since World War II have concentrated exclusively on the supply side and have ignored the need to create conditions which provided adequate demand for UK manufactured products at viable prices. At best, the Industrial Strategies which have been pursued have made some industrial activities marginally more profitable than they would otherwise have been – at the expense of the taxpayer and the rest of the economy – but never to a sufficient extent to make manufacturing in the UK as profitable as it needed to be to attract the investment and talent which was really required. The danger now is that the government will embark on another attempt at an Industrial Strategy which will have the same failings – predictably with the same lack of success which has been achieved in the past.

In fact, much the most fundamental reason for the decline of UK manufacturing is that the exchange rate has been much too high – arguably for almost all of the period since the Industrial Revolution began, but certainly for the last four and half decades. This has meant that, for a long time, it has cost more to manufacture almost anything in the UK rather than elsewhere, making light industry in the UK chronically unprofitable. This is why it has declined.



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

The graph above tells the story of the exchange rate between the UK and China – which is not a bad proxy for what has happened between nearly all of the West and the whole of the Pacific Rim. When the post-World War II Bretton Woods system broke up, inflation gripped the western world and monetarism supplanted Keynesianism. To bear down on inflation, monetarists told us that we had to reduce the money supply and raise interest rates until rapid price rises were squeezed out of the system. When their advice was followed, base interest rates in the UK rose to 15% – higher still at about 20% in the USA[20] – and as a direct result the real effective exchange rate for sterling rose between 1977 and 1981 by about 60% from its none-too-competitive rate in the mid-1970s. It then stayed at more or this level, dropping a bit in 1992 when we left the Exchange Rate Mechanism (ERM) in 1992, before starting to climb again to the dizzy heights of $2.00 to the pound in the 2000s, fuelled by massive sales of UK assets. The rate dropped 25% between 2007 and 2009 before starting to climb back again, so that the roughly 15% post referendum devaluation has done no better than to bring us back to about where we were in 2010[21].

Compare this with what happened in China which re-joined the trading world in about 1980. Over the next ten years, the Chinese real exchange rate fell by about 75% as a result of large nominal devaluations and the greatly improved efficiency with which resources, including labour, were used, as market forces were introduced. The result was that China became extraordinarily competitive just as the UK did the reverse. Hardly surprisingly, in these circumstances, almost all UK internationally tradable manufacturing was run out of business, leaving only a few exceptionally well run companies – and those with niches which gave them protection – still trading. Very importantly, the situation on competitiveness was very different in the UK for both most services and high tech industry. The UK has substantial natural advantages in the provision of services – our language, geography, political stability, legal system and the concentration of natural talent in this part of our economy – which enables services provision to thrive in an environment where comparisons are difficult and where most of what is on offer is not very price sensitive. High tech manufacturing is protected because it requires a vast amount of experience, complex supply chains, branding, and intellectual property, making it difficult to attack from a low-cost base – which is why it is still there. It is low-and medium -tech manufacturing without any of these protections which has gone to the wall because the exchange rate is too high for most UK companies to be able to compete in world markets.

This is why we have deindustrialised. It is just not possible for the average UK manufacturing company, unprotected by intellectual property, complicated processes or some other way of creating a niche, to compete in world markets. It is not, therefore, enough for an Industrial Strategy to concentrate just on supply side factors such as better education and training, easier access to funding, improved infrastructure and a more accommodating planning regime – and sometimes to more direct assistance, financial or otherwise. The problem is that none of these ways of assisting industry are effective enough on their own to make manufacturing in the UK significantly more viable than it otherwise would be, as can be seen from the decline in manufacturing as a percentage of GDP. It is the demand side of the balance which has been lacking – creating conditions in which there is enough demand for the output which British manufacturing is capable of producing to make all the supply side initiatives which the government can organise work effectively.

Profitability and the Exchange Rate

Why is the exchange rate so crucial to manufacturing? It is because most manufactured goods have generally available close substitutes, so they therefore tend to be very price sensitive. The price at which they are charged out to the rest of the world – and their ability to compete with imports – therefore makes a very large difference to their saleability

While it varies from sector to sector, ONS figures show that the average costs of producing manufactured goods in the UK breaks down to about 30% of costs being at world prices – mainly machinery, raw materials and components – and the remaining 70% being incurred in the domestic currency – sterling, of course, in the UK's case[22]. The 70% covers direct wage costs – typically about 15% of total costs – plus charges for everything else paid for locally, including management salaries and overhead costs, covering everything from travel charges to audit fees, from cleaning costs to charges for repairs and maintenance, and all forms of taxation plus a provision for profit. Suppose now that the UK exchange rate is 50% overvalued compared to the world average – which the graph on page 14 suggests may well have been the case for the UK, at least *vis á vis* China – and that a manufacturing company in a country with an averagely competitive currency charges 100 for its goods. 30 will be for costs incurred at world prices and 70 in local currency. Compare this with the UK, measuring its export prices in a world currency, such as the US dollar. The world price components still cost 30 but the domestically incurred cost are 70 x 150%, which comes to 30 + 105, a total of 135. No wonder that competing in world markets is impossible.

Obviously, to compete effectively, the exchange rate would need to be 100% of the world average and not 150%. It is often argued, however, that if the uncompetitive country moved in this direction that its imported components would become more expensive so that no competitive advantage would be secured. This perception, however, involves confusion between what is happening measured in world prices and in the domestic currency. Measured in sterling, in the UK's case, the cost of imported machinery, raw materials and components will go up but in world prices,

these increases will be exactly compensated for in the exchange rate for sterling going down. Meanwhile all the 70% of costs, measured in world prices, become a third cheaper. This is why getting the exchange rate in the right position is so crucial for the viability of most manufacturing industry.

If we really want to have an Industrial Strategy which will work, therefore, we need to do more than just stopping any more of our industrial base being eroded away. Instead, we have to rebuild our manufacturing capacity to the scale it needs to have to enable us to pay our way in the world. We need to reap the rewards of productivity increases. And we have to provide a much higher proportion of our population than we do at the moment with good manufacturing jobs. To enable us to achieve all these desirable outcomes, we need an exchange rate which is competitive enough to provide the demand side pull to which there would have to be the right supply side response. Better trained labour will have much more productive jobs to go to. Infrastructure will be much more fully used. Space will have to be found for new factories. Finance will have to be available

There will then be a crucial transition to be made. If a substantially higher proportion of UK GDP is going to have to be invested in manufacturing facilities at the same time as we want to reduce our foreign payment deficit, there is going to be a potential squeeze on consumption and thus on disposable wages. The same resources cannot be used both for consumption and investment and if, to get the UK onto a sustainable growth path, investment as a percentage of GDP had to be raised from its current less than 13% to at least 20%, savings would have to rise proportionately.

There are two solutions to this problem. One is to spread the additional savings which need to be made probably more or less equally across government, consumers, the corporate sector and – at least for a period – the foreign payment balance, so that the household sector does not have to bear too much of the burden. The other would be to get the economy to grow fast enough to enable wages to grow sufficiently rapidly to offset any increased need for saving there might be.

Another potential problem would be for there to be enough finance available for manufacturing to make the required level of investment possible. Here, we should use one of the strategies which helped Japan to grow so rapidly in the 1950s, 1960s and 1970s. This was to have banking structures put in place which allowed manufacturers to borrow on very easy terms, so that no viable industrial projects were held back by lack of money.

Careful circulations how that, if a policy along these lines were implemented, it would be possible to get the economy to grow at 4% or 5% per annum, to increase manufacturing as a percentage of GDP to around 15% and investment to 20% or more; to reduce the need for new debt to below the rate at which the economy was growing, thus making it sustainable; and to have economic growth driven by net trade and investment instead of asset inflation and consumption. This really would be an Industrial Strategy worth having. Surely, this is what we ought to be aiming to achieve.

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 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 in physical assets 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 crucial 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 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 negates any gains in competitiveness; second that devaluation is impossible to combine with an open economy; third that, if we did devalue, we would be met by retaliation which would undermine its 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 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 dozens of devaluations which have occurred among relatively rich and diversified economies such as ours in recent decades shows that in fact lower parities sometimes produce a little more inflation, sometimes a bit less, but most of the time little if any change. This may seem a very surprising result to

many people but this is unequivocally what the statistics show. Looking at recent examples, when the UK left the Exchange Rate Mechanism in 1992, sterling fell by trade-weighted 12%[23], but inflation fell from 5.9% in 1991 to 1.6% in 1993[24]. 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[25], and what increase there was in 2011 was very largely driven by an increase in commodity prices, which fell away as soon as they dropped back again[26]. The reason why these are common outcomes is that, while higher import prices push up the price level, many factors to do with a lower parity tend to bring it down. Market interest rates tend to be lower after a devaluation, and so do tax rates. Production runs become longer, bringing down average costs. Investment, especially in the most productive parts of the economy, tends to rise significantly, increasing output per head, reducing costs and producing a wage climate more conducive to keeping income increases in line with productivity growth. Furthermore, as domestic supplies of goods and services become more competitive with those from abroad, demand switches to local sources, negating the need to pay higher import prices even if foreign suppliers reduce their prices to try to retain market share.

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

Changing the Exchange Rate in an Open Economy Next, it is frequently contended that the parity of sterling is determined by market forces over which

the authorities have little control, so that any policy to change the exchange rate in any direction is bound to fail. Again, historical experience indicates that this proposition cannot be correct. 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[27] as a result of deliberate policy. Further back, the Plaza Accord, negotiated in 1985, produced a massive change in parities among the major trading nations of the world at the time, causing the dollar, for example, to fall against the yen by just over 50% between 1985 and 1987[28].

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 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."[29] It may, therefore, very well be the case that in the foreseeable future there will be a change in market sentiment

which will bring sterling down to a lower parity with or without the assistance of the authorities. The fall in the value of sterling following the EU referendum in June 2016 has already shown this happening, although the fall from $1.45 to $1.25 is unfortunately still not enough to precipitate a large scale industrial revival.

Retaliation If the UK were to devalue by a sufficient amount – probably about 20% from its current $1.25 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 begins. The curse of foreign payment imbalances starts not with countries like the UK, with massive deficits, but with countries such as Germany, Switzerland and the Netherlands with huge surpluses – in 2015 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] – as well as the post-EU referendum drop in sterling's parity, all engendered no retaliation. All were evidently seen by other countries – the markets and the authorities – as being exchange rate adjustments which were clearly warranted by the state of the UK economy. Against the background of our currently ballooning foreign exchange deficit, there is no reason why the same could not be made to happen again. If the manifest imbalances in the UK economy are clearly associated with an unsustainably high exchange rate this should also enable us to overcome any objections from our G7 partners, with whom we have jointly agreed not to indulge in unwarranted competitive devaluations.

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

The first is that if we reduced the value of the pound by, say, 20%, in world currency terms, we would make ourselves 20% worse off and we would therefore genuinely be poorer by this amount. The fallacy with this argument is that, while it might be well founded if we did all our shopping in international currencies such as dollars, this is not what UK residents do except perhaps when they go on holiday. UK citizens pay for almost everything they buy in sterling and it is therefore GDP measured in sterling, not in dollars, which counts. This is 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 prudence and the link between sterling and gold, combined with the dominance of financial interests over those of industry, all stretching back to the beginning of the nineteenth century when industrialisation in the UK really got under way, have always hobbled British industry. Although we initially showed the way, other countries have overtaken us as their industrial bases have got stronger and their more competitive currencies have allowed them to secure better net trade advantages.

As these other countries have invested more heavily in the future than we have, their output per head has grown more rapidly than ours, their wage climates have been better and their inflation rates have been lower. As an extreme example, in Switzerland, between 1970 and 2010, the price level rose by 88%. In the UK it increased by 780%. The average annual Swiss inflation rate over these 40 years was 1.6% while in the UK it was 5.6%[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 for sterling to drop. 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 early in the 1980s and later in that decade as the UK entered the Exchange Rate Mechanism, which we left in 1992 with a devaluation of about 12% against all currencies[40], to escape from a sharp economic downturn. After showing some signs of recovery, the UK economy then became more and more unbalanced as assets sales, starting in the late 1990s on a scale unparalleled anywhere else, pushed sterling up to 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 to roughly where we were in 2010 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 whatsoever 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 , 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, given devaluations of a sufficient size.

It is true, nevertheless, that some recent studies[42] have shown that the responsiveness of the UK economy to a lower exchange rate is relatively low. If the exchange rate is much too high, however, and it has been over-valued for a long time, this is bound to be the case. We know that – for different reasons – services and high tech manufacturing are not very price sensitive. Light manufacturing output is much more price sensitive, but the UK has too little of it at present to have a major impact on overall elasticities. As we have seen after the EU referendum, however, a lower exchange rate does help exports but mainly by increasing foreign sales from existing production capacity. The crucial point to grasp is that really big increases in price

sensitivity only materialise when it becomes worthwhile for companies not just to increase existing production in the UK for export but to site new production here rather than elsewhere in the world. Price elasticities depend much more on decisions on where manufacturing is to be located than they do on the volume response from existing production.

The reason why the UK has allowed manufacturing as a percentage of its GDP to fall from almost 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 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. This is where the right type of Industrial Strategy could play such a key role.

For both the government and the UK's political class generally this may be a crucial test. The problem at the moment is that neither the government nor the opposition has a credible economic policy to deal with the UK economy's fundamental problems. There are no meaningful plans for getting the economy rebalanced onto a long-term sustainable growth path which will achieve significant improvements in living standards. There are no policies which will get the economy re-industrialised.

Plans for investment are largely 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. There is no policy for reducing borrowing – indeed the reverse is in prospect if a significant public sector investment programme is to be undertaken, financed by increased government debt. There is 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, asset inflation and equity realisation. Above all, no-one at present has anything to say to the millions of erstwhile supporters for the moderate right and left, whose confidence in the London-based political class is being lost because there are no policies on hand to reverse the negative impact which most of these voters have sustained because of globalisation's impact on their employment prospects.

Instead, at present, all that is on offer – at best – is a watered down version of the Conservative economic policies which were in place until the summer of 2016 – slightly less austerity financed by rather more borrowing. A major problem which Labour, in particular, then faces is that, actually, current Conservative policies, however sub-optimal they really are, 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. 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 benefitted 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 curse. 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.

The UK therefore has a choice to make – indeed a choice shared by moderate left and right of centre parties all over the West. Do we maintain our current economic policy stance – a pale and increasingly unconvincing version of the Neo-Liberalism which has served the West so badly over the decades since the Keynesian post-War consensus broke up? Or do we strike out into new territory which may grate initially against the conventional wisdom but which would be capable of transforming our economic prospects – and making an Industrial Strategy really worth having?

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For the first time for decades, the government is interested in having an Industrial Strategy. The combination of our yawning balance of payments deficit, the anger at lack of good manufacturing job prospects exhibited by the EU referendum result and the increasing imbalances between London and our erstwhile industrial heartlands have pushed deindustrialisation towards the top of the government's agenda.

Industrial Strategies have a chequered history in the UK, however, and have not done much, if anything, in the past to stop manufacturing as a percentage of UK GDP falling from nearly a third in 1970 to barely 10% now. This is because they all concentrated exclusively on supply side rather than demand led factors.

The Industrial Strategy we need now is one which complements exchange rate and monetary policies to generate demand with all the changes on the supply side necessary to enable the economy to produce the industrial renaissance we need if we are to rebalance our economy towards sustainable growth and rising living standards.

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