# HEALING THE WOUNDS

How to make Brexit a success; how to spread the benefits of globalisation more fairly; and how to make the UK economy perform better and more inclusively.

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# HEALING THE WOUNDS

## Tackling the economic challenges post-Brexit

This pamphlet is about three overlapping subjects of pressing interest to everyone concerned with the economic and political future of the UK. The first is how we handle our relationship with the European Union, following the result of the referendum held on 23rd June 2016. The second is what we do about the huge divisions in the UK highlighted by the referendum result. The third is why and how we need to get the UK economy to perform better and more inclusively.

## The UK and the EU

The outcome of the EU referendum was a relatively small but still decisive 3.8% majority in favour of Leave. London, Northern Ireland, Scotland and some other metropolitan centres voted Remain but the majorities in these areas were overwhelmed by Leave votes elsewhere, particularly in the Midlands and the North of England. Most people were taken aback by the huge disparities in the voting outcome, demonstrating, as they did, how divided the country has become. As much as anything, the divide in the way in which votes were cast was between those parts of the country which have done well out of globalisation and those which have not. Many of those supporting Remain are not only disappointed but shocked by a result which they did not expect and for which they were ill-prepared. Those who

voted Leave, on the other hand, while pleased with the result, are also concerned to see how little preparation had been done by the Leave camp to plan what happened next if the vote went their way.

There is indeed a rock-strewn path ahead. At least two thirds of all MPs supported Remain rather than Leave and the assent of Parliament is bound to be required for any final settlement which the UK negotiates with the other EU member states. The Labour Party may be in turmoil in other respects, but it is still very largely united in favour of EU membership, even though this is not a view shared by somewhere close to 40% of those who voted Labour in the 2015 general election. The Conservatives have been distracted by choosing a new leader and the new Prime Minister, Theresa May, did not support Brexit. The government therefore has been through an indecisive period before getting itself into a position to define what needs to be done to implement the referendum result.

Meanwhile, the EU is in a far from stable condition with a looming banking crisis in Italy, another bail-out in prospect in Greece, a number of difficult general elections coming up – especially those in Germany and France in 2017 – and discontent manifesting itself in the rise in protest parties across the continent. The EU referendum may be only the first of a number of democratic upsets which the EU will have to weather as the imperative for closer integration to save the single currency grates more and more roughly against the increasingly clear perception among the EU electorate that their primary loyalty and focus is on the nation state rather than the supra-national EU.

In the UK, there is now going to be pressure across the political spectrum for action to be taken to deal with the outcome of the EU referendum. The decision to leave the EU was backed by a completely unprecedented number of votes cast on a single issue in any democratic decision taken by the British people. It cannot be ignored without deepening still further the distrust with which the UK's political class is held. Implementation is fraught with particular problems for the Labour Party, now facing an existential crisis exacerbated to a substantial extent by the gulf shown

during the referendum between official Party policy and the way in which many Labour-leaning people cast their votes.

Of the nine million people who voted Labour at the 2015 general election, a detailed poll published recently by Lord Ashcroft[1] indicates that 37% – about 3.3m – of these Labour supporters voted Leave in the referendum. If this number of people desert the Labour Party because they think that, from their perspective, its stance on the EU is much too Europhile, most Labour MPs with majorities of less than 5,000 would lose their seats and Labour representation in the next Parliament would drop by perhaps a hundred. To win these potentially lost voters back, the Labour Party will have to do something about both democratic control and immigration – the two main drivers of the Leave vote – but doing so is likely to be incompatible with the Party's current aspirations to minimise the impact of Brexit by campaigning for the UK to remain in the Single Market after leaving the EU.

Nor are the Conservatives problem-free. They too have large numbers of MPs who supported Remain as well as electing a new leader who did the same thing. About 60% of Conservative voters voted for Leave but this still leaves a large minority who did not do so. Whereas Labour is united on policies which are strongly opposed by a large minority of its potential supporters, the Conservatives are more likely to reunite round a post-Brexit EU exit strategy which most of them would support, but they have a minority who look as though they might prefer to derail the whole Brexit process if they could.

There are also acute issues around timing. Article 50 of the Lisbon Treaty stipulates a two-year period for negotiation but this has to be triggered by the government giving notice that it wishes to start the withdrawal process. There is disagreement about when this should be done. Once negotiations start, it's quite possible that they may take longer than two years to conclude, in which case there has to be agreement, which may not be forthcoming, to extend the negotiation period.

There are also complications about who will represent the EU in the negotiation process to come, which is in two parts. One concerns the process of disengagement,

which will probably be in the hands of the European Commission, where qualified majority voting will apply. The other concerns arrangements, notably on trade but also on many other matters, where individual nation states of the EU may get involved – making endorsement of any agreement reached much more difficult to secure.

There is, therefore, a way ahead in which the UK could very easily get bogged down. We could then quickly find ourselves in the worst of all worlds – still effectively in the EU but on worse terms than before, partly as a result of action being taken against the UK to discourage other countries from following us out of the Union and partly because being halfway in has none of the advantages of either full membership nor independence. We therefore very urgently need a strategy which could cope with all these problems and pitfalls; which would be acceptable across most of the UK political spectrum; which would maintain relations with the rest of the EU on as cordial a footing as possible, and which could be achieved with both reasonable speed and certainty. It is against this background that, in principle, at least, there is an increasing measure of consensus about the approach which needs to be adopted.

## The case for exiting the Single Market

The key factor is the attitude to be taken by the UK is our continuing membership of the Single Market. Undoubtedly, there are large numbers of people and interest groups who put a very high store on our remaining within this fold. We are in the Single Market now, and staying in it provides continuity, giving UK exporters the certainty of tariff free access to the EU's five hundred million consumers. Threatening to withdraw from it – or actually doing so – might undermine business confidence, depressing investment and growth prospects. There may be technical difficulties on issues such as certificates of origin, although fears on this count appear to be overblown judging by the huge volumes of goods sold to the EU by many countries outside the Single Market without apparently encountering these problems. It might also make it more difficult for us to co-operate fruitfully with the

EU on other non-trade issues if relations between the UK and the EU were allowed to deteriorate as a result of the UK no longer being in the Single Market. These are important and serious considerations. But they need to be weighed against a number of crucially important arguments for the UK being prepared to leave the Single Market altogether.

A significant starting point is that, following the referendum, it is clear that the UK is going to have to press for changes in our relationship with the EU, involving the Single Market, which are going to be contentious and difficult to negotiate. To reflect the result of the referendum – and to deal with what is clearly a major national concern – some reasonably substantial restrictions are going to have to be put on migration from other EU countries to the UK. Unlike most other EU member states, the UK's population is growing very fast – by about 550,000 a year, about 165,000 of whom are net EU migrants. This is putting an increasing strain on social infrastructure such as our hospitals, schools, housing, and our road and rail system. There are also particular concerns about competition in the employment market among workers on low incomes. It is not at all clear or certain, however, that the EU is going to agree to any curbs on free movement being put in place if we remain a member of the Single Market, at least not without very substantial concessions being demanded elsewhere.

It is not just migration which is a problem with our Single Market membership. As long as we are a member of it, we are bound to accept all the obligations which it's Directives and Regulations, justiciable by the Luxembourg court, impose upon us. We are also likely to have to continue paying a large contribution to the EU budget. If we are not an EU member any more we would not be part of the EU's decision making process but if we were still in the EU Customs Union, we would be precluded from having our own membership of bodies such as the World Trade Organisation (WTO). There would thus be a real danger that we would be in the disadvantageous position of being obliged to accept all the obligations of the Single Market, as we are now, but having given up any control over any new ones. Overall, the renegotiation of our role within the Single Market would probably be fractious and time consuming, with uncertainty pressing us towards accepting a poor deal.

A much better initial approach, therefore, would be for the UK to sidestep these problems by making it clear that we were willing to withdraw from Single Market membership and that negotiations for the future would have to start on this footing. This would be a much simpler and quicker process than renegotiating complex derogations from the inside. This is so because UK trade with Europe does not depend on EU goodwill; although the terms on which it takes place are subject to EU control. Trade access is guaranteed by the WTO and by other existing treaty obligations. The price to be paid for being outside the Single Market but with no free trade deal with the EU is that we would have to accept WTO tariffs on all our visible exports to the EU. These now average about 3%, although the amount to be paid on agricultural products (about 20%), vehicles (up to 10%) and some manufactured goods such as textiles and shoes, are considerably higher. It may be, therefore, that if the EU insisted on having tariff barriers against imports from the UK, we would have to engineer a rather lower exchange rate to ensure that our competitiveness was maintained. Services would be tariff free although subject to non-tariff barriers – as indeed many of them are now.

The crucial point is that access to the Single Market does not depend on us being a member of it, as is often alleged. On the contrary, it depends on our being able to supply goods and services at competitive prices, as is the case with all the countries, such as China and the USA, which export to the Single Market without being members of it.

If, however, the EU had tariff barriers against exports from the UK, there is no reason why the UK could not reciprocate by charging import duties on imports from the EU. As the EU sells far more to the UK than vice versa – £68bn in 2015[2] – tariff barriers at the WTO level on trade between the UK and the EU would be even less in the interest of the EU than the UK. This would then provide the basis for negotiating a free trade agreement between the UK and the EU, which would benefit everyone. How long would this take? After Norway rejected EU membership in 1972, the Norwegians negotiated a trade deal with the EU in just under eight months. It might take rather longer than this but with the prospect of German car manufacturers and French wine producers losing market share in the

UK, the pressure to get a deal concluded within the two-year period allowed by the Lisbon Treaty would be substantial.

Partly related to how we handle our relationship with the Single Market are some important issues concerning the City where there are already tensions because we are not in the Eurozone. The EU has always been relatively backward in establishing a genuine Single Market for services, particularly financial services, and there may well be efforts to constrain the City's role in dealing with Eurozone transactions. Whether these would be successful, however, remains to be seen, particularly as new regulations come into play at the beginning of 2018. This latest Directive on Markets in Financial Instruments will allow financial dealing to take place in any state where the regulations were internationally accepted on an "equivalence" basis, thus bypassing the EU's "passporting" requirement which would otherwise have been needed. London is a major European and global financial centre and there is no reason to believe that this will change. The City stands to gain from no longer being bound by unhelpful EU regulations, but it is very much in the UK's interest to avoid excessive discrimination against the UK in the provision of financial services within the EU. Looking forward, however, the City's main competitors will not be Paris or Frankfurt but Hong Kong, Singapore and New York. The City has enormous locational, linguistic, legal and cultural advantages and it will naturally adjust to make the most of new opportunities as they materialise all over the world.

## Additional benefits of leaving the Single Market

If we are outside the Single Market and free to set our trading terms generally, there are then a number of other steps which we can take to improve the UK economy's medium- and long-term prospects. Generally, the more outward facing and non-protectionist the policies we pursue, the more likely we are to see our economy flourishing, although it is crucially important that the numbers of those who are adversely affected is kept to a minimum and that those who do lose out are compensated and protected. Although, as a bargaining counter, we would almost certainly

choose to erect tariffs against EU exports to the UK, if they did the same to us, it would actually be better for us to allow them tariff free entry to the UK market, provided that the UK exchange rate kept us competitive. If we were outside the EU's Common External Tariff, we would no longer be obliged to maintain high tariffs on agricultural products and reducing these to zero, while compensating the farming community, would have very substantial welfare benefits, especially for poorer people. Food prices might be lowered by as much as 20% but certainly a reduction of 10% should be possible[3].

An important corollary to this would be our approach to the Common Agricultural Policy and the Common Fisheries Policy. Neither have any significant support within the UK. The CAP has been responsible for regressively high food prices ever since we joined the Common Market in 1973. It has been hugely wasteful and very damaging to third world countries. The CFP has been even worse, decimating our once-rich fishing grounds and almost totally undermining our fishing industry. There would be major advantages to us in extricating ourselves from both these policies, saving ourselves large sums of money in the process.

As regards inward industrial investment, we would need to make sure that the UK continued to be an attractive place for businesses orientated to selling their products in the EU by a combination of supply side and demand side policies, to ensure that the UK was at least as competitive a location as it is now and hopefully much more so. Our trading position in the world could then be enhanced by free trade treaties which have so far eluded the EU because of the difficulties involved in getting 28 member states all to agree on the contentious elements which always abound in all trade treaties. This is why the EU does not have trade treaties in place with any of the major economies in the world such as China, Japan, India, Australia or the USA. Negotiating on our own, we should be able to do much better than this. Furthermore, by formally coming out of the EU we would at least substantially reduce the prospect of heavy additional financial obligations being placed on the UK if the Eurozone breaks up, leading to widespread bank failures.

# Conclusion: Renegotiation

The UK is not, therefore in a weak negotiating position on exiting the EU, although we should be careful not to overplay our hand. Our objective should be to get a fair deal which benefits both us and the EU and one which should be stable and viable. We need to respect the Eurozone's requirements for further integration to protect the single currency while noting the strains which this puts on democracy within the EU. We should wish them well with this project while being thankful that we are not part of it. Elsewhere, we should continue to co-operate with our near neighbours on everything where working together makes sense – from counter-terrorism to climate change, from health to education, on sustainability and diplomacy and from protecting the environment to standardising products.

The outcome could then be what the vast majority of people in this country really want as the basis of the relationship with the countries close to us in Europe: free trade and close friendship and co-operation; but on the basis of inter-governmental co-operation rather than as part of an overarching political project.

We would be outside the Single Market and thus clear of its regulations and directives; no longer constrained by the Luxembourg court and thus able to make our own decisions on social and employment policies; in a position to make our own decisions about who comes to live in the UK, and able to run a non-discriminatory immigration policy between EU and non-EU citizens; and no longer liable to pay the very heavy annual membership fee which we are obliged to meet every year as matters stand at present.

We are already outside the Euro and the Schengen agreement, and thus relatively well protected from the financial and migratory crises the EU faces at present. We would be free to take up our roles on world bodies such as the WTO and to negotiate trade treaties with whichever countries we thought appropriate. We would be in a position to face out to the world, lowering tariffs particularly on food rather than embracing the protectionism which is never far below the surface in many EU countries. We would be back in control of our own destiny.

If we could achieve all this, we would be a long way down the track of getting our relationship with the EU onto the sort of footing which would be widely supported in the UK, hopefully by many who voted Remain in the recent referendum as well as those who chose Leave. These steps would hopefully make the UK more at ease with itself in a number of crucial respects. It would still leave a very unbalanced economy in the UK, however, with much that needed to be done to get it back onto a more even keel.

## Rebalancing the UK economy

There was a very clear reason why the referendum result went the way it did. There was pent-up anger in much of the UK on a much larger scale than most people in the prosperous South East realised could exist. This stemmed from a number of sources: wages which had been stagnant at best but often falling since 2008; disillusionment with London-based politicians of all persuasions because they appeared to have little idea what to do with the economy to make it grow; poor and insecure job prospects with many of the positions that were available not being full time; increasing poverty especially among those in work but struggling to make ends meet; resentment at the impact of immigration on over-stretched resources; bitterness at widening income and wealth disparities and inequality in life chances generally both between socio-economic groups and regions of the country; more resentment at the disparaging way in which provincial culture and values were regarded by the metropolitan elite; and a general feeling that most people had inadequate control over their future prospects and those who were in a position to determine what they were.

Essentially the divide between those in areas which voted for Remain and those which opted for Leave was between those who had benefited from the increasingly divided state of the nation – and in particular those who had done well out of globalisation – and those who had suffered from it. This was a particularly acute problem for Labour which naturally tended to elect MPs from poorer areas of the

country. Despite the Party's strongly pro-EU official stance, 70% of Labour-held constituencies had Leave majorities. Many of these were in areas where previous prosperity depended on good-quality manufacturing jobs, which had largely – or in some cases entirely – disappeared. This left employment prospects dependant on relatively low-productivity service sector jobs and whole communities unable to pay their way in the world, and consequently dependent on government subsidies which never seem to be available in sufficient quantities.

How can these problems be tackled? How can we produce better job prospects for millions of people, raise living standards and reduce inequality? There is a way ahead, but it means as much of a change to the way the UK runs its economic policies as the now-projected change in our relationship with the EU. The starting point is to realise just how unbalanced the UK economy has become. There are at least five ways in which current trends are unsustainable.

## Low levels of investment in the UK

The first is that we invest far too low a proportion of our national income and where we do spend money on equipping ourselves for the future it is mostly in areas of expenditure which do little to increase productivity. The UK spends 13%[4] of its Gross Domestic Product (GDP) on physical investment, i.e. excluding intellectual property, which is far below what is achieved almost everywhere else. The world average is almost twice as much, at about 24%, while in China the ratio is almost four times as high, at close to 50%[5]. Not only is the total quantity of investment in the UK far too low, but relatively little of it goes on the narrow range of activities which actually have the ability to produce big increases in value added or output per hour. These are essentially in machinery and technology and almost nothing else. In fact, of the 13% of GDP which we do devote to investment only a quarter goes on Other Machinery and Equipment – the closest category the Office for National Statistics (ONS) has to a class of expenditure embracing machinery and technology[6] – and this is before deducting depreciation which is about 11.4% of

GDP[7], leaving almost nothing left. Indeed, what remains is far too little to stop our accumulated assets being diluted down by our rapidly rising population. This, in a nutshell, is why we have both static productivity and consequently no increases in average real wages and such pressure on our schools, hospitals and infrastructure.

## Industrial decline in the UK

Second, we have deindustrialised to far too great an extent. As late as 1970, almost a third of our GDP came from manufacturing. Now it is barely 10%[8]. A combination of the huge increase in the exchange rate between the 1970s and the early 1980s – an increase of about 70%[9] – wiped out a good deal of the UK's manufacturing capacity, and the further increase from the late 1990s onwards as a result of the UK selling off vast quantities of UK assets accounted for much of the rest. More or less any manufacturing involving low- or medium-technology which was subject to international competition became unprofitable. All that is left, with few exceptions, are manufacturing activities, such as mechanical repairs and some sorts of food production, which have to be local and thus not subject to international competition and high tech industries such as arms, aircraft and their engines, pharmaceuticals and vehicle production. They survived because their complexity, high levels of intellectual property protection and branding, complicated supply changes and their requirement for accumulated experience made them much more difficult to attack from low cost economies than manufacturing which required more broadly known and available technology. Time, however, is not on the side of even these high-tech industries as China's aerospace and India's pharmaceutical industries are developing at an incredibly rapid rate.

Deindustrialisation on this scale matters hugely for a number of reasons. The lack of good manufacturing jobs has had a huge negative impact on both the areas of the country where manufacturing used to be important and on living standards and prospects for the people living there. Gross value added, on average, is much higher in manufacturing than in services[10] and the very large disparities – now in a ratio

as high as two to one – which are apparent between living standards in some parts of the South East and other areas in the North of England is very largely due to the collapse of manufacturing in our erstwhile industrial heartlands.

In addition, productivity increases are far easier to secure in manufacturing than in services. Installing a machine which makes two of something in replacement for one which makes one with the same inputs literally doubles productivity in a way which it is extremely difficult to replicate in service industries.

Finally, the UK economy, despite the harsh way in which its manufacturing industry has been treated, still depends much more on goods than on services for its export earnings. The problem is that we do not have enough now to sell abroad to pay our way in the world, and that leads on to the third major imbalance in the UK economy, which is our foreign payment balance.

## Our balance of payments deficit

Figures recently published by the ONS show that the UK is now running a balance of payments deficit which is close to 7% of our GDP[11]. This means that, on average, everyone in the UK is enjoying a standard of living which is 7% more than we are earning. This catastrophic state of affairs has arisen because the trade surplus which we have on services – £89bn in 2015 – is far smaller than our deficit on goods – £125bn the same year. Added to the trade deficit are two other major components of the adverse balance. One is transfers to other countries which are running at about £25bn net, split roughly 50% on payments to the EU, 25% on migrants' remittances abroad and 25% aid programmes. The other is net income from abroad which used to be a large positive figure but which has now become even larger but negative, trending towards a figure which may be as high as £60bn in 2016. The main reason for this is that the cumulative effect of successive years of overall deficits of about £100bn a year, which have to be financed by the sale of UK assets or by borrowing abroad with an average gross return of about 5%, has worsened the income deficit

by about £5bn a year in recent years. As long as deficits of anything like the current magnitude continue, the balance of payments trends can only get worse[12].

## Debt and missing demand for UK goods and services

Our balance of payments deficit is then at the root of our next major problem which is the accumulation of more and more debt. The reason why this connection is so strong is because the effect of balance of payments deficits is to suck demand out of the economy as more payments go abroad than are received by the domestic economy. This lost demand has to be replaced, if the economy is not to go into a downward spiral, and the only way for this to be done is by expenditure to be undertaken which is unfunded by income – i.e. by borrowing. This can be done either by the corporate sector disbursing more than the profits it is earning, or by consumers borrowing so that they can spend more than their incomes or by the state running a deficit as its outlays exceed its revenues. At the moment, all three of these sectors are net borrowers. At annualised rates based on the outcome of the first quarter of 2016, the corporate sector is borrowing £31bn, consumers £17bn and the public sector £66bn to finance a total foreign payments deficit which (allowing for a significant £15bn statistical discrepancy) is trending towards £129bn.

The creation of debt, by itself is not necessarily a source of difficulties. Since civilisation began thousands of years ago, borrowing and lending have oiled the wheels of both countries, governments, the corporate sector and private individuals. Debt only really becomes a problem when the cost of servicing it and being able to repay it gets too large to handle and debtors begin to worry that creditors will not be able to meet their obligations. At the moment, the UK government is still highly creditworthy in that it can borrow all the money it needs at very low interest rates; the corporate sector is flush with cash and consumer debt, at prevailing very low interest rates, is not generally a major problem, although a significant proportion of individuals are in personal financial difficulties.

There are, however, major problems with overall debt increasing at the rate it is. One is that, sooner or later, this process will become unmanageable if the rate at which debt is increasing is much higher than the growth rates, which is the case at the moment. The other is that the accumulation of debt is a major drag on economic growth as those who might otherwise have invested in the future have to devote more and more financial resources to service current liabilities. Government investment in infrastructure gets constrained; businesses feel more nervous about laying out money on new projects; consumers get more cautious; and economic prospects worsen as everyone's confidence in the future is reduced.

## The growth conundrum

And this leads on to the fifth overall problem. To maintain demand in the face of balance of payments deficits syphoning demand out of the economy governments have no alternative but to resort to more and more extreme policies to increase borrowing and lending. This is what has produced Quantitative Easing as huge sums were lent by the Bank of England to the clearing banks to try to get them to lend more. Government deficits, nevertheless, remain stubbornly in place despite repeated promises from the Chancellor the Exchequer that they will be brought down to zero within a short number of years. Taxes on business are reduced in desperate attempts to try to make them invest. Asset inflation is encouraged to give consumers the confidence to spend. The problem is that none of these policies work at least in the sense that the more they are applied the less effective they become. This is why they have failed to get the UK economy to grow to any significant extent ever since the 2008 crash.

## Conclusion: Economic imbalances

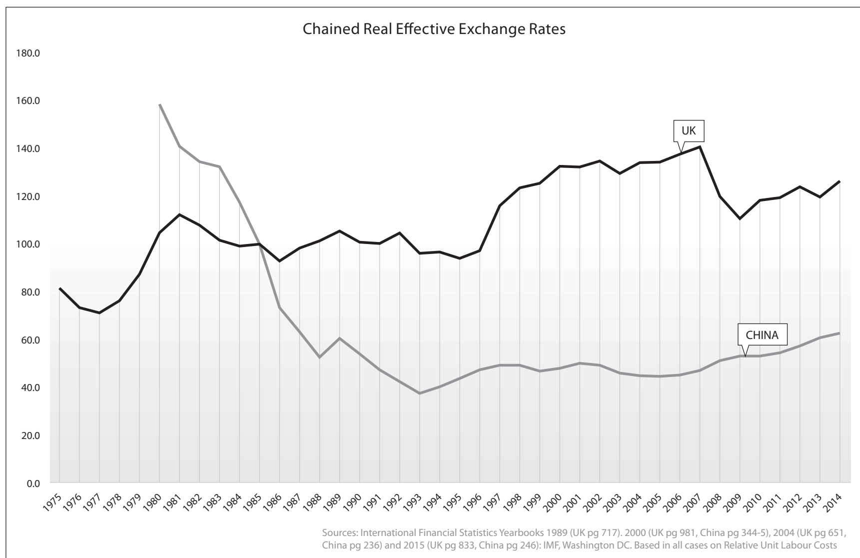
These, then, are the acute imbalances from which the UK suffers. We invest much too little of our national income, which is why productivity is static; we have deindustrialised to a point where we cannot pay our way in the world; we have chronic balance of payments problems which are only financed by selling off UK assets and borrowing from abroad at unsustainable rates; we are running up debts much faster than our capacity to service or repay them; which crowds out investment and depresses confidence; but meanwhile we are propping up demand with more and more borrowing and debt as a result of policies which, like a drug, are becoming more and more ineffective the more they are used.

None of these policies, however bad they have been for the economy as a whole, have hit very hard those who have done well out of the economy as rewards have become more uneven. The UK is a wonderful place to live for perhaps the top third of the income profile, partly because both globalisation and immigration have helped to enhance their lifestyles. International travel and connections are great for those who can afford them, while immigration provides the well-off with a willing and hard-working supply of plumbers, waiters, au pairs and gardeners. For those further down the income ladder, however, it has been much tougher.

The reality is that globalisation and immigration have hugely benefited a relatively small but very economically and politically powerful segment of the population, leaving far too many other people no better off than they were a decade ago. How do we overcome these problems, rebalancing the economy and giving hope to the millions of people who have become so disillusioned and angry because they have been left behind?

# Competitiveness

There is an overarching reason why the UK economy is so unbalanced, why wages and living standards for most people are static and why many of the trends which our economy exhibits are unsustainable. We are living in a fool's paradise because we have completely misjudged the significance of competitiveness on our position in the world and on the effect this has on our relations with the economies with which we trade and with which we have to compete.




The graph above encapsulates our exchange rate history for the last forty years, using the UK as a proxy for most of the western world and China for the resurgent East. Between the late 1970s and the early 1980s the UK's real exchange rate rose by about 70%. It then plateaued for the next fifteen years before starting to rise steeply again as we moved into the 2000s. It fell between 2007 and 2009 but by nothing like enough to offset the previous rise and since then – until very recently, especially post the EU Referendum – it has been trending back up again. Meanwhile, over the decades since China joined the international trading community around 1980, the

Chinese hugely increased their competitiveness, especially during the early years, partly by devaluing their currency and partly by vastly increasing efficiency as they moved towards a market economy. The graph shows the huge gap in cost, measured by real effective exchange rates, which was the result.

For typical manufacturing operations, about one third of total costs are raw materials and machinery, for which there are world prices and two thirds are locally determined and paid in the local currency – sterling, of course, in our case. The two thirds covers everything from wages to profits, from cleaning costs to bus fares, from audit charges to nearly everything which is bought in from UK-based suppliers. If the exchange rate goes up by, say, 50%, some simple maths shows that total production costs – measured in world rather than local prices – increase by two thirds of 50%. This is essentially what happened in the UK and the result was that nearly all UK based manufacturing which was subject to competition from the Far East got wiped out.

This analysis also shows us what we have to do to get our economy rebalanced. We have to get the sterling component of manufacturing costs – the UK's cost base – down to a point where low- and medium-tech operations can compete again in the world economy. To rebalance the UK economy we need to get the proportion of GDP coming from manufacturing up from 10% to at least 15% and to do this we need an exchange rate which is roughly £1.00 = $1.00 or perhaps $1.10. And we would have to make it clear that it was settled government policy to keep it at this level, so that investors and entrepreneurs had enough confidence in the future competitiveness of the UK's cost base to make the necessary plant and machinery investments in our future.

What would be the benefits? The economy would be rebalanced. The opportunities for investment in manufacturing would push the proportion of GDP devoted to investment up and the improvement in the balance of payments position which a lower pound would achieve would enable the state to match higher private sector investment with increased spending on our physical and social infrastructure – hospitals, schools, housing, road, rail etc.. Deindustrialisation would be reversed

as manufacturing grew as a proportion of GDP towards around 15% – the level it has to achieve to enable the UK to pay its way in the world. Much better net export performance – exports minus imports – would bring the balance of payments deficit down to manageable proportions. We do not need a surplus but we do need to ensure that the deficit as a percentage of GDP is less than the growth rate, to ensure that our overall position is not deteriorating. The rate at which debt generally was accumulating would again fall to below the growth rate, which is the condition needed for sustainability. Growth would be driven not by rising consumer demand but by investment and net exports.

The revival of manufacturing would enable us to start taking advantage again of the big productivity increases that light industry more than any other sector of the economy is capable of achieving. Prosperity would be spread throughout the country rather than being concentrated in the South East. Hope would revive in the parts of the country which would now be able to benefit from the upsides of globalisation rather than its downsides. Why don't we do it? The main reason is that, for a whole variety of historical and cultural reasons, we are wedded to the mistaken idea that the stronger the pound is the better and that undoing this condition is impossible. This is not the case. It can be done and we ought to do it.

## Objections to devaluation

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 value of sterling down to a level which makes a number of objectives possible to achieve. We need to invest more; to reverse deindustrialisation; to get our balance of payments position under control; to stop accumulating debt at the present rate; and to get economic growth driven by net trade and investment instead of by consumption.

Many people, however, even if they were persuaded by the logic of this case, would be inclined to shy away from trying to implement it because of deeply held suspicions that such a policy would neither be achievable nor would it work even if it could be put into practice. There are six main arguments which are regularly advanced to support these contentions. They are first that devaluation always produces extra inflation which negates any gains in competitiveness; second that devaluation is impossible to combine with an open economy; third that, if we did devalue, we would be bound to be met by retaliation which would undermine its benefit; fourth that reducing sterling's parity would make us all poorer instead of better-off; fifth that we have tried devaluations in the past and they do not work; and sixth that the UK is no good at manufacturing and that our economy would not therefore respond positively to a lower exchange rate. None of these allegations stand up to close scrutiny and a central part of the case put forward in this pamphlet is to understand why this is so.

**Devaluation and Inflation** The contention that devaluation always produces a rise in inflation is true in so far as it applies to goods and services which are imported. Price rises here are inevitable and a necessary part of switching demand from international to domestic suppliers. It does not, however, follow that the price level generally will rise more quickly than it would have done without a devaluation and a wealth of evidence from the dozens of devaluations which have occurred among relatively rich and diversified economies such as ours in recent decades shows that in fact lower parities sometimes produce a little more inflation, sometimes a bit less, but most of the time little if any change.

This may seem a very surprising result to many people but this is what the statistics show. Looking at recent examples, when the UK left the Exchange Rate Mechanism in 1992, sterling fell by a nominal trade weighted 12%[13], but inflation fell from 5.9% in 1991 to 1.6% in 1993[14]. 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[15], and what increase there was in 2011 was very largely driven by an increase in commodity prices, which fell away as soon as they fell back again[16].

The reason why these are common outcomes is that, while higher import prices inflate consumer prices, many factors to do with a lower parity tend to bring them down. 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 away 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 trading characteristics tend to do better and better as highly productive investment is attracted to those sectors of the economy most likely to produce rises in productivity and increasing competitiveness. This is the environment into which a considerably lower exchange rate parity needs to draw the UK economy.

**Changing the exchange rate in an open economy** It is also 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 is not 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[17] 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[18].

It is of course true is that market forces have a major influence on exchange rate parities but it is not true is 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 value. If the markets think that the Bank of England is going to raise interest rates, this will also push sterling higher. If the Bank wants to help to keep the value 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 to keep the exchange rate as high as it has been recently. 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's law has it – incidentally with balance of payments deficits as a prime example – "Trends that can't continue, won't"[19]. 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, as indeed has happened post the June 2016 referendum outcome.

**Retaliation** If the UK were to devalue sterling by a sufficient amount – probably about 25% from its present level of around $1.30 – 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 case, 15% for the Swiss and nearly 10% for the Netherlands[20]. 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.

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 their being major international consequences. The fact that our share of world trade is now so low – at 2.6% in 2014[21] – 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 value of sterling when the UK left the ERM in 1992 – a trade weighted drop of 12%[22] – and the fall in the rate for sterling against the dollar between 2007 and 2009 – about 25%[23] – both engendered no retaliation. Both were seen by other countries, the markets and the authorities, as being exchange rate adjustments which were clearly warranted by the state of the UK economy. Against the background of our currently ballooning foreign exchange deficit, there is no reason why the same could not be made to happen again.

**Sterling and living standards** It is frequently argued that a devaluation must make us all poorer and this argument tends to take two forms, neither of which are correct. The first is that if we reduced the value of the pound by, say, 25%, in world currency terms, we would make ourselves 25% worse off and we would therefore genuinely be poorer by this amount. The fallacy with this argument is that, while it might well be well founded if we did all our shopping in 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 figures do not generally show falls in GDP after countries devalue their currency. On the contrary, they almost invariably show the growth rate rising and GDP increasing as a consequence. Since living standards closely approximate to GDP per head, if the economy is increasing in size and the population growth does not outpace economic growth, 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 a higher proportion of economic production is exported, 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[24].

**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 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 over a long period 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%[25]. It was against this kind of background that from time to time the over-valuation of sterling would became so obvious that either the markets or the authorities or both tolerated, engineered or encouraged the parity for sterling to fall. The fall, by about 30% in 1931 – after near stagnation during the 1920s – enabled the UK economy to have its fastest spurt of growth ever during the middle of the 1930s – 4.4% per annum cumulatively for the four years between 1933 and 1937[26].

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 to $2.80[27]. Much higher than average inflation in the UK than elsewhere and underinvestment in export industries resulted in a steady deterioration in the 1950s and 1960s, culminating in the pound being devalued in 1967 from $2.80 to $2.40[28]. Once currencies started to fluctuate against each other in the 1970s, following the break-up of the Bretton Woods fixed parity system in 1971[29], high inflation combined with high interest rates kept sterling much too strong, especially as the UK entered the Exchange Rate Mechanism at the end of the 1980s, followed by leaving it in 1992, with a devaluation of about 12% against all currencies[30]. 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, since when its value has fallen back a bit but not nearly enough. Meanwhile, in the East exactly the opposite policies were followed as several countries massively devalued their currencies.

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 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 are uneconomic in the UK at present, because the exchange rate and the cost base for them 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 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[31], 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 seen 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, which is at the bottom of the imbalances from which the UK suffers which, in turn, are the wellspring of so much discontent, to continue.

## Liberal democracy

Finally, more may be at stake than just static living standards, increasing inequality and decreasing confidence in the ability of our political elite to deliver acceptably successful policies. Liberal democracy depends on there being a substantial amount of trust between the government and the electorate. There needs to be at least a reasonable amount of confidence among those who are governed that those who are in charge know what they are doing. The problem, not just in the UK but across most of the western world, is that this trust and confidence is eroding away. Part of the reason for this lack of trust is ineffective economic policies which have generated little or no growth, static incomes and poor prospects. But polls taken after the UK referendum showed that another major factor was that those voting for Leave felt that they had much too little control over their futures, that too many of those taking decisions for them were unelected and unaccountable, and that there was a cosy elite which was adept at looking after its own interests but had little regard for the culture, attitudes and values of much of the electorate.

These are very dangerous trends. The moderate right and moderate left, who have largely supported recent trends both as regards the EU and the unsuccessful and divisive economic policies pursued in the West since the 2008 crash, are mostly in retreat. Their place is being taken by parties of the left and right with more extreme positions, often nationalistic and protectionist and sometimes either millenarian or racist. They oppose austerity but have no coherent plans for making their economies perform better. They are thus all too likely to disappoint their supporters, leading to more instability.

The EU performed a vital role in bringing together France and Germany after all the bloodshed of the first half of the twentieth century but the risk now is not of countries in Europe going to war with each other. It is of a break-down in the democratic political process as elections produce factions which cannot agree with each other, leading to governmental chaos, potentially followed by civil disobedience and violence. In the meantime, we have states in East Asia, with much more authoritarian traditions than ours but doing far better than we are economically and with governments which at least seem to be able to get decisions taken and to get things done, presenting an example which could easily further undermine the appeal of liberal democracy.

Creating new relations with the EU and tackling our deep-seated economic problems in a rational way are therefore of crucial importance. They overlap and go together. If we handle both of them successfully, the UK's future could be very bright but if they are mishandled the future for the UK – and probably for the whole of the West – could be very much darker. We are in grave danger of living on borrowed time.

# Notes and references


1. Poll published by Lord Ashcroft entitled “How the United Kingdom voted on Thursday . . . and why.”
2. Table C in *Balance of Payments 2016 Q1*. London: ONS, June 2016
3. Calculations done by Professor Minford at Cardiff University
4. Table F in *Quarterly National counts 2016 Q1*. London: ONS, June 2016.
5. World Bank internet entry on Gross Capital Formation by country.
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7. Page 774 in *International Financial Statistics 2013*. Washington DC: IMF 2014.
8. ONS spreadsheets GDP (O) Low Level and LPROD02. Total Labour Force is at Q3 each year.
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13. Page 981 in *International Financial Statics Yearbook 2000*. Washington DC: IMF, 2000
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31. *Does Exchange Rate Policy Matter? European Economic Review* vol 30 (1987), page 377, reproduced on page 63 of *International Finance* by Keith Pilbeam, Basingstoke, UK: Macmillan, 1994 and *A Method for Calculating Export Supply and Import Demand Elasticities* by Stephen Tokarick. Washington DC: IMF Working Paper WP/10/180, published 2010

The referendum held on the UK's membership of the European Union on 23rd June 2016 produced a result which was unexpected by the political class either in the UK or in Brussels and for which they were very ill-prepared. Nearly everyone hugely underestimated the pent up anger, manifested in the referendum's pattern of voting, largely caused by the way in which in which recent economic developments, particularly globalisation, had disproportionately benefited the metropolitan elite at the expense of the wider community.

The discontent stemmed from a number of sources: wages which had been stagnant at best but often falling since 2008; disillusionment with London and Brussels based politicians of all persuasions who appeared to have little idea what to do with the economy to make it grow; poor and insecure job prospects with many of the positions that were available not being full time; increasing poverty especially among those in work but struggling to make ends meet; resentment at the impact of immigration on over-stretched resources; bitterness at widening income and wealth disparities and inequality in life chances generally both between socio-economic groups and regions of the country; more resentment at the disparaging way in which provincial culture and values were regarded by those in the Westminster bubble; and a general feeling that most people had inadequate control over their future prospects and those who were in a position to determine what they were.

What is to be done to overcome all these problems? This pamphlet highlights the pressing needs there are to tackle three inter-related issues. The first is how to handle productively and successfully our relationship with the European Union in the light of the decision taken by the British people to leave the EU. The second is to tackle the root causes of the huge divisions – largely caused by the collapse of manufacturing in the UK – which were highlighted by the referendum votes. The third is to determine why the UK economy has become so unbalanced, with a trajectory which is unsustainable, and to analyse what needs to be done to get it to perform better and more inclusively.

These are the themes which Labour Future has been established to address, and this pamphlet sets out what we believe are the solutions to the problems which the pamphlet describes.

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