Why is the UK economy growing at less than half the world average rate?

How to rebalance the UK economy to make it grow sustainably at 3% to 4% per annum

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Preface

The UK economy has underperformed for many decades. Unless we start to consider new fresh ideas about why this has happened and what we can do about it, we will continue to flounder with profoundly negative impacts on our future prospects.

That is why I am working with the Institute for Public Policy Research (IPPR) to launch a competition this Autumn with a substantial £100,000 main prize. This will be awarded for the best entry showing how the growth rate of the UK economy could be increased on a sustainable basis to about the world average, which has recently been 3.5% per annum.

Entrants to the competition will, however, have to break new ground because economics, at least as it is presently taught and practised in the West, provides no guide to our policymakers on how to generate any chosen economic growth rate. This is why the West has allowed itself to be eclipsed in the growth stakes by the East for the past 40 years.

What would we have to do to achieve much better results? Would it really be possible? The text which follows sets out what I believe is a convincing path to getting our economy to grow at 3% to 4% per annum – whatever, incidentally, the outcome of the current Brexit negotiations.

What I propose should be done may not, however, turn out to appear to be the best way ahead. Hopefully the competition will produce an even better plan, but at least the text which follows shows what might be possible and sets the bar.

Between 2005 and 2016 our cumulative growth rate was 1.4% per annum – 60% below the world average. Surely we can do better than this. The object of the competition is to raise our sights, to get people to think afresh about why the country which provided the birth of the Industrial Revolution is doing so poorly, and to provide ourselves – and particularly the majority of our population who have languished for far too long with stagnant or falling real incomes – with hope and the resources for a better life.

The competition is open to any individual or group, and full details are available from the IPPR by contacting Catherine Colebrook at c.colebrook@ippr.org. For social and political as well as economic reasons, I do not believe that we can afford to have stagnant incomes and no real wages increases for most of the UK population for the next decade.

John Mills

Why is the UK economy growing at less than half the world average rate?

There is a pressing need to get the UK's economic growth rate up – and not just because most people clearly want this to happen. Failure to achieve this goal also has numerous other undesirable consequences. It promotes widening divisions in the country. It undermines trust in our political leadership. It reduces our status in the world. And it leaves support for the liberal democracy which underpins our way of life increasingly under threat. For all these reasons, it is of key importance that we get the rate of economic growth in the UK up from where it is now.

At present, nevertheless, there are few people who believe that the UK economy is likely to grow during the coming years at a rate greater than somewhere between 1.5% and 2% per annum. Indeed, there is a fair chance that the average growth rate over the next few years, whatever happens to the Brexit negotiations, may well be at the lower end of – or even below – this range. Especially if this is the case, most people, who have seen no increase in their real wages for the last ten years, will be no better off in ten years' time than they are now. At the same time, the rich look set to become wealthier, the inequalities between generations are likely to increase and the gap in living standards between London and the rest of the country will probably widen still further. This is an exceedingly gloomy prognosis both economically,

socially and politically. It is a future which we need to avoid if we possibly can.

Why will real incomes for most people stay static if the economy is growing at, say, 1.5% per annum? It is because the same forces will be in play as those that explain why the median income has not grown for the past ten years. Our population is growing at about 400,000 per year, diluting down GDP per head by about 0.6% per annum[1]. At the same time, our huge balance of payments deficit is siphoning some £30bn[2] every year away from the total sum available for UK incomes; the share of wages and salaries as a percentage of GDP is slipping down; and those with sharp elbows tend to collar what little increase in the total income pot there is. There is no sign of any of these trends reversing, and, therefore, the economy is becoming a ball and chain around the ankle of the nation's poorest. If real wages for most people are to start rising again – and we are to stop falling behind the rest of the world – we will therefore have to do much better than we are now. Specifically, to get the UK economy to grow fast enough to be sure that we can raise real wages for almost everyone, we need to get the UK economy to grow cumulatively at somewhere between 3% and 4% per annum. Is this possible? The text which follows argues that it is, but only with a radical re-think to how economic policy is formulated and executed in the UK.

Investment

The reason why the UK economy performs as poorly as it does, compared with much of the rest of the world, is that in a number of respects it is extraordinarily unbalanced. For a start, investment in the UK currently accounts for just less than 16% of GDP according to the Office for National Statistics (ONS)[3] – 17% in IMF publications[4] – compared with a world average of 26% and about 45% in China[5]. The figure of 16% – which was 19% as late as 2008[6] – includes investment in intangibles which the Office for National Statistics (ONS) designates as "intellectual property". Excluding this component, tangible investment accounts for no more than 12.6% of GDP[7]. As depreciation is running at almost the same rate[8], after taking this into account, practically nothing is left. Further analysis shows the situation to be even worse than these total figures might suggest. In particular, investment in "Other machinery and equipment", which covers the most highly productive forms of investment in terms of productivity growth, has fallen by 25% as a percentage of GDP – from 3.6% in 2008 to 2.7% in 2017[9].

This is far the most important reason why productivity in the UK is virtually static, particularly when the key characteristics of different types of investment are taken into account. Some sorts of investment have a much larger impact on the growth rate than others. In particular, there are three types – mechanisation, technology and power – whose emerging salience 250 years ago provided

the foundation for the Industrial Revolution, generating much faster economic growth than had ever been seen before. Their key characteristic is their ability vastly to increase output per hour, typified by a bulldozer replacing a shovel, a computer being used instead of a multiplication table, a lorry/truck being employed instead of a wheelbarrow, a combine harvester replacing a sickle, or a new machine being installed which produces a multiple per hour of the products compared to the one it replaces. The benefits derived from investment of this type are then diffused through the economy as higher output, increased wages, better and cheaper products, greater profits, and a larger tax base – all building up to produce a social as opposed to just a private total rate of return.

Total returns to the economy from different types of investment can then be quantified. Most public-sector investment – in road, rail, schools, hospitals, public facilities and housing – however important it is in social terms – has a low social rate of return and does not contribute much, if anything, to increases in GDP. The same is true of much private sector investment – in office blocks, shopping centres, new restaurants and IT installations to support financial and legal services. Mechanisation, technology and power, on the other hand, can produce much higher social rates of return, typically running at 50% per annum or even more. The Social Rate of Return is defined here as the ratio, calculated over a reasonable length of time, between the increase in GDP and Gross Expenditure on Investment over the same period. Gross Investment as a percentage of GDP multiplied by the

Social Rate of Return – by definition – then equals the Average Growth Rate.

GROSS INVESTMENT, SOCIAL RATES OF RETURN AND GROWTH RATES FOR SELECTED COUNTRIES AND PERIODS

Country	Period	Gross Investment as a % of GDP	Average Social Rate of Return	Average Growth Rate
UK	1934-1941	14%	37%	5.6%
USA	1939-1944	7%	144%	10.1%
Japan	1953-1970	29%	35%	10.1%
China	2002-2012	37%	25%	9.1%
Korea	2005-2016	30%	12%	3.5%
Singapore	2005-2016	26%	20%	5.3%
UK	2005-2016	17%	8%	1.4%
World	2005-2016	26%	14%	3.3%

NB. the Gross Investment figure for the USA for the period 1939 to 1944 covers private investment only, so the average Social Rate of Return for the US economy as a whole must have been lower than 164%.

Evidence that much higher social rates of return than those being currently achieved in the UK is readily available. To take some extreme examples, illustrated in the table above, Japan achieved a 35% average annual social rate of return on all its gross investment for the whole of the period 1953 to 1970, with physical investment

accounting for just under 30% of GDP[10]. No wonder the Japanese economy expanded by 10% per annum cumulatively over these two decades. The USA had an extraordinary period between 1939 and 1944 during which its economy doubled in size. This was achieved because relatively modest amounts of investment –heavily concentrated in manufacturing to support the war effort – produced an average social rate of return which appears to have been in excess of 100%[11]. The UK also had a golden period from 1934 to 1941 when the average social rate of return was 37%, with 14% of GDP devoted to physical investment, producing a cumulative growth rate between 1934 and 1941 of 5.2% – a much better growth performance than has been seen at any time before or since[12].

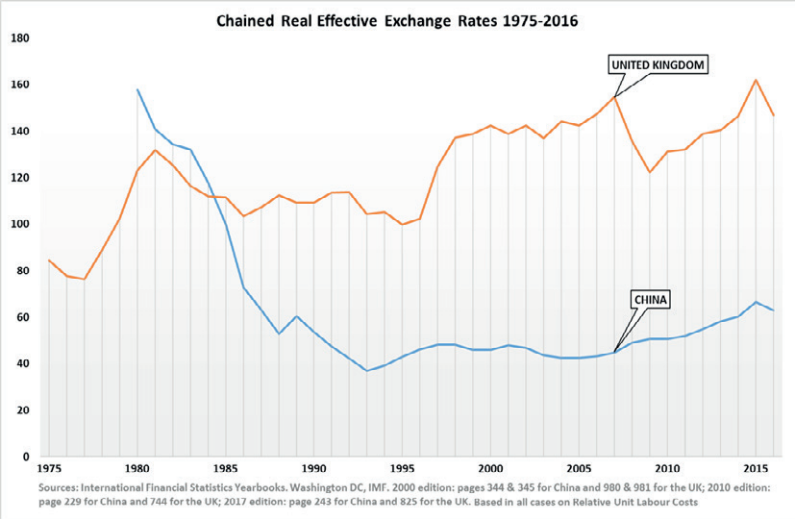
Moving to more recent times, the huge expansion in the Chinese economy has been driven by both high social rates of return and a high proportion of GDP being devoted to investment. Over the period between 2002 to 2012 China's social rate of return averaged 25% while the proportion of GDP devoted to investment averaged 37%[13], producing a cumulative growth rate of over 9% per annum. Also showing what can be done by a much richer economy, between 2005 and 2016, the Singaporean economy grew cumulatively by 5.3% per annum with a social rate of return of 20% and 26% of GDP accounting for investment[14]. South Korea, by contrast, grew over the same period by an average of 3.5% per annum with a social rate of return of 12% but with 30% of GDP going into investment[15]. In the UK, at the same

time growth averaged 1.4% per annum, the social rate of return was 8% and the proportion of GDP devoted to investment, including IP, was 17%, falling to barely 12% if IP is excluded[16].

Measurements of total gross investment inevitably include large outlays on types of investment which self-evidently we know have low social rates of return. Furthermore, gross investment figures take no account of depreciation. It is impossible, then to avoid the conclusion that, to achieve the average figure that the statistics show, in the right circumstances the social rate of return on the most productive investment must be comfortably in the 50% per annum region – and higher still in the most favourable cases.

Most of the investment which has these very high-powered characteristics tends to be found in the private rather than the public sector, pre-eminently in light industry although some is in the service sector. It will therefore only materialise if there is a reasonable chance of it being profitable. The problem in the UK is that the exchange rate has for many decades been much too high for this condition to be fulfilled. This is why we have deindustrialised to the extent we have.

The following graph shows movements in the real exchange rate between the UK and China – which is a reasonable proxy for what has happened between most of the West and most of the East over recent decades. The UK economy was none too competitive in



the late 1970s when the advent of monetarism, which then morphed into neoliberalism, hugely raised interest rates, with base rates – let alone market rates – peaking at 14.875% in 1989, with another peak at 13.875 in 1986[17]. The exchange rate rose by over 60% in real terms between 1977 and 1982[18] as the battle to control inflation took centre stage, while any collateral impact on UK competitiveness of the policies adopted to control price rises was simply ignored. Worse, however, was to follow. After some respite post 1992 when the UK fell out of the EU's Exchange Rate Mechanism (ERM), sterling strengthened again as the economy was liberalised in terms of capital movements to an extent unrivalled anywhere else in the world. The result was huge capital inflows as vast swathes of the UK economy – our ports, airports, energy companies, utilities, football clubs, large sections of what was left of our manufacturing base,

and much else – were sold to foreign interests. Between 2000 and 2010 net sales overseas of UK portfolio assets – shares in existing companies, bonds and property but excluding direct investment in buildings and machinery – are reported by the ONS to have totalled £615bn[19]. No wonder that, as a result, the pound soared again until by 2007 it was worth more than $2.00[20].

Because the world market for goods is very competitive, it is hardly surprising that UK industry reeled under this onslaught. On average, about one third of total manufacturing costs consist of machinery raw materials and components, for which there are generally world prices[21]. All the other two thirds of charges – for direct labour, management and all other overhead costs including interest and a provision for taxation – are incurred in sterling and the rate at which they are charged out to the rest of the world is directly reflected in the exchange rate. As a first approximation, therefore, and as an example, the 60% increase in the real exchange rate in the late 1970s and early 1980s added two thirds of 60% – i.e. 40% – to the underlying costs of UK exports, while making imports correspondingly cheaper.

Concern over the decline of manufacturing in the UK, has a long history although the many reports which have been produced to remedy matters have turned out – almost without exception – to be ineffective, with consequences of our poor economic performance often being misdiagnosed as causes of it. Broadly speaking the left has favoured state intervention to improve educa-

tion and training, to make finance more readily available to industry, to change company governance to reduce "short-termism" and to canvas for increases in public expenditure to improve the infrastructure. The right on the other hand, has favoured more competition, lower taxes, privatisation, deregulation and a smaller state. While both these approaches may have some merit in appropriate circumstances, there is little evidence that, on their own, either of them is going to make a material positive difference to the way the economy operates. The reason is that neither of them gets to the core problem which is that, unless investment is likely to be profitable, it will not be undertaken by businesses in the private sector, which have to make a profit to survive.

If we are going to get the economy to grow more rapidly, therefore, we have to change the economic incentives available to both existing companies and to new entrants. We have to make investment, especially of the high-powered type, profitable enough to attract resources, so that we can make it materialise on a much larger scale than it is now in the UK. If this can be done, however, the prospects for lifting the growth rate from 1.5% to 3.5% become much more promising. Essentially what needs to be done is very simple. It is to shift around 4% of our GDP out of consumption and into investment with a 50% social rate of return. 4% x 50% provides the 2% difference between 1.5% and 3.5% growth per annum.

Deindustrialisation

The second major imbalance in the UK economy is that our manufacturing base has been allowed to diminish to an extent which surpasses what has happened to any other major developed nation. It is true that there is a tendency for all advanced economies to see their service sectors expanding at the expense of manufacturing. This is partly a price effect as the cost of manufactured goods falls while those of services rise. It is also the case that the borderline between manufacturing and services is sometimes blurred. Making full allowance for all these factors, however, does not alter the fact that the UK has deindustrialised to a much greater extent than almost anywhere else. Even as late as 1970, about 32% of UK GDP[22] came from manufacturing. Now the percentage is 9.7% and still slipping downwards[23].

The extreme case of deindustrialisation from which the UK suffers is a major drawback for the economy for four separate but overlapping reasons. The first is that productivity increases are much easier to achieve in manufacturing than they are in services, so the smaller manufacturing is as a percentage of GDP, the lower the growth rate is likely to be. Below is a table which shows the high correlation there is across a range of economies between those which have strong manufacturing sectors and relatively high growth rates and those that do not do so. The major reason why productivity growth tends to be higher in light industry is because mechanisation, technology and power, the most productive forms of

GROWTH, MANUFACTURING AND INVESTMENT AS A PERCENTAGE OF GDP IN VARIOUS COUNTRIES

	China	Korea	Singapore	Germany	Holland	USA	UK
Growth in GDP 2006-2016	136%	39%	59%	19%	9%	14%	12%
Growth in population 2006-2016	5.6%	3.9%	21.9%	0.5%	3.3%	8.2%	8.2%
Growth in GDP per head 2006-2016	124%	33%	30%	19%	6%	5%	3%
Manufacturing as a % of GDP	29%	29%	20%	23%	12%	12%	10%
Investments as a % of GDP	45%	29%	27%	19%	19%	20%	17%

Sources: Various tables in *International Monetary Statistics Yearbook 2017.* Washington DC: IMF, 2017. Manufacturing data from the World Bank website. This data relates to 2016 as does the IMF data on Investment as a % of GDP.

investment in terms of added output per hour, tend to find a natural home in this part of the economy.

The second reason why manufacturing is so important is that it provides regions of the UK outside the South East of England with output to sell, so that they can pay their way. At present, large swathes of the UK run huge deficits with the rest of the world. If London runs a balance of payments surplus, which it does, the rest of the country has to share out the UK's balance of payments deficit.

Clearly some cities – Oxford, Cambridge and Bristol, for example – are doing reasonably well, but this means that perhaps three quarters of the economy – about £1.5bn per annum in total turnover – is sharing out a deficit which is probably as high as £150bn, implying that about three quarters of the UK is running at an average deficit of something like 10%. No wonder that there are such huge disparities in Gross Value Added per employee as the statistics show – an average in 2015 of £44k in London and £18k in Wales and £19k in the North East[24].

Third, there is substantial evidence that on balance manufacturing employment provides a more satisfying job environment than much service sector employment. This is partly because there may be intrinsic satisfaction to be gained from making things but also because the pattern of employment in manufacturing tends to be more evenly spread across skill and ability levels than in services, which are more inclined to produce large numbers of jobs which are either highly skilled or relatively unskilled, with a gap in the middle. Despite the cavalier way in which manufacturing has been treated in the UK, average wages there are still substantially higher than they are on average in services – with a gap in manufacturing's favour currently running at almost 20%[25].

Finally, producing manufactured goods is key to the ability of the UK – or any other advanced and diversified economy – to pay its way in the world, and because our manufacturing base is so weak, we have a very large

deficit on goods – £135bn in 2017[26] – of which £98bn was manufactures[27]. Although the UK does well on net export of services, with a surplus in 2017 of £107bn, this still left a substantial trade deficit gap of £29bn, contributing to our next major problem, which is our balance of payments deficit.

Balance of Payments

On its own, a trade deficit of around £30bn for an economy with total GDP of approximately £2trn should not be too big a problem. Unfortunately, however, as the following table shows, the UK's foreign payments position is much weaker than this. We are in this position because of two other major factors.

One is that we have a large and increasing negative net income from abroad. As recently as 2011, we had a surplus, but the balance has deteriorated sharply since then, the underlying reason being that every year we have a current account deficit, we have to borrow from abroad or to sell assets to foreign interests to finance it. All the time we do so, the interest and profit remittances we have to pay abroad go up, increasing our negative net income from overseas. The other additional burden on our balance of payments deficit is in the form of net transfers abroad. About half of these are net payments to the European Union, with the remainder being split roughly equally between net remittances abroad by immigrants to the UK, and the cost across the exchanges of our aid programmes.

UK BALANCE OF PAYMENTS BREAKDOWN – NET FIGURES IN £BN

Year	Goods Balance	Services Balance	Trade Balance	Primary Income	Secondary Transfers	Total
2007	-88.6	53.6	-35.0	-7.2	-13.1	-55.3
2008	-91.7	52.7	-39.0	-14.6	-13.2	-66.8
2009	-85.3	57.0	-28.3	-11.5	-14.8	-54.6
2010	-95.6	60.5	-35.1	1.1	-19.6	-53.6
2011	-94.4	75.9	-18.5	6.5	-20.3	-32.2
2012	-106.7	81.1	-25.6	-17.8	-20.4	-63.8
2013	-119.0	90.0	-29.0	-36.4	-25.3	-90.7
2014	-122.1	92.4	-29.7	-37.8	-23.4	-90.9
2015	-117.8	90.8	-27.0	-43.0	-23.2	-93.2
2016	-132.6	101.8	-30.9	-49.4	-22.5	-102.8
2017	-137.0	114.3	-22.7	-32.8	-21.0	-76.5

Source: Time Series Dataset. London: ONS, September 2018

It is simply unsustainable for the UK to continue indefinitely running a balance of payments deficit every year of about £100bn, which is roughly 5% of our GDP[28]. The rest of the world is not going to support the British people enjoying a standard of living 5% higher than they are earning forever. Sooner or later, the markets are going to realise that the current dispensation cannot last, and that sterling will have to become weaker to take the strain. We need to catch this situation and to take advantage of it before we get forced into a damaging and pointless retreat, while the defensive action we take to keep the pound stronger than it should be means years more of pointless and unnecessary austerity and low growth.

Two other issues to do with our balance of payments deficit are worth highlighting. One is that all our deficit and more is with the EU27[29] and not – in aggregate - with the rest of the world, where we have a small surplus[30]. Although it does not really matter with which countries we have a surplus or a deficit if the total balances are within tolerable limits, the fact that all our foreign payments deficit is with the EU27 is clearly a factor which ought to bear on our current Brexit negotiations, although this important topic is barely – if ever – mentioned. The other is that the exchange rate has a big influence on the size of the net-income-from-abroad element of our deficit. The stronger sterling is, the larger the sterling returns from the UK economy to foreigners become and the smaller is the sterling value of profit remittances and interest payments from abroad. A weaker pound would thus not only make our exports more competitive and reduce import penetration. It would also reduce the scale of our negative net income from abroad.

Debt

There has been a staggeringly large increase in debt within the UK economy since the turn of the century. By 2016 the total monetary base in the UK economy had grown to almost 15 times the size it had been in 2000[31] – a period when the economy grew in real terms by no more than 32%[32]. There are two interlocking reasons why this has happened, and both involve heavy distortions and mismanagement in the way the UK economy is structured.

UK NET LENDING (+) AND NET BORROWING (–) BY SECTOR IN £BN

Year	Public Sector	Corporations	Households NSSZ	Rest of World NHRB	Totals
2008	-81.9	-13.9	29.1	66.5	0
2009	-159.3	23.3	81.8	54.4	0
2010	-147.8	10.0	83.4	54.4	0
2011	-122.5	31.8	57.7	33.0	0
2012	-137.6	10.6	62.6	64.4	0
2013	-93.7	-43.1	44.9	91.9	0
2014	-99.0	-38.7	44.9	92.8	0
2015	-80.5	-73.8	59.2	95.1	0
2016	-58.1	-63.3	16.8	104.5	0
2017	-38.8	-31.2	-20.7	80.8	-10.0

Source: Time Series Data supplied by the Office for National Statistics. London, September 2018. Figures for 2017 are still being reconciled by ONS. The net totals will also be zero when this process is complete.

The first is that over the years since 2000, the UK has sustained balance of payments – usually large ones – almost every year. The total accumulated deficit between 2000 and 2017 came to just over £1trn[33]. The table above shows how this impacted on borrowing and lending within the UK economy between the more recent years 2008 to 2017.

The crucial take from this table is that it highlights that all borrowing and all lending – and all surpluses and all deficits – have, as an accounting identity, to sum to zero. Unless completely implausible assumptions are made about borrowing and lending by corporations and households, a substantial balance of payments deficit –

represented in this context by lending to the UK from the rest of the world – is therefore bound to leave the government with a large deficit, which is exactly what has happened. This means that reducing the government deficit by cutting expenditure or raising taxes – however, intuitively obvious it may seem that this must be the right way to bring government borrowing down – is built on a fallacy of composition. This is the assumption that what might make sense for an individual would be equally appropriate for the economy as a whole. It may well be the case that individuals living beyond their means need to reduce their expenditure or to increase their incomes to bring their finances under control. If the state does this, however, its impact is not to reduce its borrowing but to tip the economy towards a recession – as austerity policies have done – as social expenditure goes up and the tax take falls, leaving the deficit substantially where it was before. The reality is that the only way to bring the government deficit under control without plunging the economy into a recession is to reduce the foreign payments deficit – something which successive governments, Labour, Coalition and Conservative, have done little or nothing to try to achieve.

If any government was nevertheless determined to reduce its deficit to zero by cutting expenditure and raising taxes whatever it took, it could succeed, but at huge cost. This is what happened in Greece over the period 2008 to 2014. Deflation took place on a sufficient scale to reduce imports to match Greek exports, eliminating the previous balance of payments deficit and thus bringing

the government budget back into balance. The result, however, was to reduce Greek GDP by over a quarter in real terms[34]. This is hardly a recipe for running a successful economy in the interest of all its citizens. The UK government has had to run large deficit because, unless we had done so, we would have suffered from the same problems as have been inflicted on Greece.

The reason why our huge balance of payments deficits have inflated the money supply as well as encouraging austerity is that the fiscal restraint which has been attempted in cutting back public expenditure has had to be offset by relaxing the money supply to stimulate expenditure to avoid the economy sliding backwards. This has been done by massively increasing the monetary base via Quantitative Easing, reaching a total of £435bn[35], accompanied by rock bottom interest rates. This has made it easier for those who were already credit-worthy to borrow more. The result has been a massive increase in asset prices, which in turn has increased consumer confidence and led to consumer expenditure-based increases in demand. Consumer expenditure as a proportion of UK GDP, at 84%, is substantially higher than in almost any other country in the developed world[36].

The risk that we now face is that the large amount of corporate and household borrowing which is shown in the table above melts away as confidence falls, leaving the public sector with no alternative but massively to expand again the deficit on which it operates. This will leave the government facing another huge increase

in its borrowing requirement, further destabilising the country's national finances. Instead, we need to pay our way in the world, to live within our means and to pay off some of our debts instead of carrying on as we are, constantly putting off the evil day when reality catches up with us by borrowing more and more.

Inequality

The final major imbalance in the UK economy is around inequality – with three main dimensions. These are disparities in living standards and opportunities between London and the South East and the rest of the country; the gap which has opened between the achievements and prospects between millennials and those born a decade or two earlier; and between those who are wealthy and those who have not been so lucky. All countries have inequalities and those living in democracies are usually sufficiently realistic to realise that there are always going to be differences in living standards, prestige and esteem enjoyed by some people compared to others. Furthermore, it is easier to accept that some peoples' living standards are rising faster than others if almost everyone is experiencing some improvement. A much less acceptable situation is reached, as is now the case in the UK, when at least half the population have static or falling real incomes while a privileged, but not particularly deserving minority, are clearly doing very much better.

Reference has already been made to the huge disparity there is between Gross Value Added (GVA) generated

per employee in London compared to poorer regions such as Wales and the North East. It is not just these static comparisons, however, which are so worrying. It is the direction of travel. There is no sign of the gap narrowing. On the contrary, over the past few years, the disparities have widened. It now seems hard to believe that until about the 1960s the north of England was richer than the south[37] and there was a time not so very long ago when Bradford, now one of the poorest places in the country, was among the most prosperous cities in the UK[38].

What has happened, particularly recently, is that average living standards in London have risen in line with GDP while in poorer regions they have fallen back. Between 2007 and 2013 in the North East they fell by about 9% and in Wales by 10%, whereas in London they more or less held their own[39]. This happened because the relatively disadvantaged areas of the country simply do not have the capacity currently to pay their way in the world. This is why they depend on grants, transfers, loans and asset sales to cover the gap between what they earn and what they spend. Especially at a time and in a climate of austerity there is never enough to reverse the remorseless underlying trends towards cut-backs to try to make the books balance.

The inter-generational inequality problem is a new one, at least on anything like the scale which is now apparent. It centres round the inability of so many young people either to obtain satisfactory employment, paying

a reasonable wage or salary for a fulfilling job, or being able to buy a house or flat to provide a secure base for raising a family, thus frequently having either to stay with their parents or renting at exorbitant cost. Some of the problem on the income side has been caused by the hollowing out of the labour market as jobs, especially in the service sector, as remuneration polarises at either end of the income spectrum. Part comes from the heavy bias there is in the education system towards academic rather than vocational training, leaving students, often weighed down with heavy debts, struggling to find reasonably paid employment which matches their qualifications. Part comes, especially outside London, from poor employment prospects generally.

The collapse of house-building since the 1960s[40] has generated a massive shortage of accommodation as the number of housing units expanded far more slowly than potential household formation. During the 1960s, the UK constructed an average of just over 300,000 units of accommodation a year. By the 2000s this performance had fallen to less than 150,000 per annum, with local authorities building only a derisory average of 224 units per year compared to 147,000 in the 1950s[41]. This situation has been aggravated by the major banks lending far more liberally for house-purchase than for any other types of loans, driving up prices beyond the capacity of large sections of the population to pay them. The result is pessimism and discontent – and distrust in the way the country is being run – among large sections of the rising generation.

The distribution of income has actually become slightly more even over the last decade, partly because the really huge bonus payments paid in financial services during the run-up to the crash have fallen out of the income profile and partly because of the impact of rising minimum wages and tax changes. The same cannot be said, however, for wealth and life chances generally. Low interest rates and Quantitative Easing have produced an enormous boom in the value of assets and a huge increase in wealth and life-chance inequalities as these conditions have benefitted those already well off far more than those not so fortunate. Examples of this happening are that the average value of housing in the UK as a whole rose between March 2009 and November 2017 by 46% and in London by 96[42]. Since the lowest point during the 2008 crash until January 2018, the FTSE 100 index has risen by 119%[43] As the economy stabilised after the crash, total wealth held by the top UK decile rose between 2010 and 2014 from 25 times what was held by the bottom decile to 34 times[44].

There are solutions to all these problems, but all of them require higher levels of investment, better job prospects, reindustrialisation and a higher rate of economic growth. There is little doubt that the regions of the UK outside London would be much more prosperous than they are at present if the proportion of UK GDP accounted for by manufacturing rose sharply, enabling them both to raise living standards directly and to pay their way in the world, thus making them much less dependent on subventions from elsewhere. Rebalancing the UK econ-

omy towards manufacturing more generally would make our foreign payments position much more manageable and sustainable as well as producing better job prospects and productivity increases generally, leading to higher rates of economic growth. The millennial generation would also benefit from new job opportunities, especially if they were allied to much better and appropriate training for new employment prospects which faster growth would open up. If much higher levels of investment included a major housebuilding drive, as it should, there would be some light at the end of the tunnel for those desperate to get on the housing ladder. A huge amount therefore turns on getting the economy to perform better. How can it be done?

Solutions

The fundamental problem with the UK economy is that overall it is uncompetitive. We charge out all our sterling based overhead costs to the rest of the world at too high a price. We can get away with doing this in services and indeed also in most high-tech manufacturing because both these sectors are relatively price-insensitive. Our services in addition generally also enjoy substantial natural advantages – our language, our geography, our legal system, our universities and where we have concentrated our skills – from which they strongly benefit. This is why they provide us with a services trade surplus. The problem is that most of our international trade is not in services but in in goods, where we have no clear natural advantages, and we do not have nearly enough to sell

to the rest of the world every year to cope also with our other heavy foreign payment commitments. The only way out of this dilemma is for us dramatically to improve our net trade balance in manufactures.

And the only way to do this is to make manufacturing in the UK more price competitive, which requires action on both the demand and supply side of the equation. On the demand side – contentious though this may be – we need a much lower exchange rate. On the supply side we need to mobilise all the components of the industrial strategies and the need for encouraging open markets and competition on which there is broad agreement, which will only be effective if the requisite demand is there. How low would the exchange rate have to be to make such a policy work? Essentially it would have to be low enough to make it worth siting new manufacturing facilities on a broad scale in the UK instead of elsewhere, and this takes us to the overall sensitivity of exports and imports to changes in the price at which they are offered.

Exports – in particular – react to price changes in two separate ways. If the exchange rate goes down and demand increases, manufacturers' first reaction is to squeeze more production out of existing facilities. Their ability to do this is, however, inevitably constrained by the spare capacity they have available. To go on expanding supply, new plant has to be installed, and the crucial determinant as to whether this will materialise in the home economy or elsewhere is whether there are reasonable expectations that keeping production local will pay

off in the medium to long term. The investment needed will not materialise if decision-makers think that the exchange rate is going to strengthen again and international competitiveness to fall correspondingly as soon as the government can make this happen, or if the lower exchange rate, even if likely to be maintained, is not sufficiently competitive to make it worthwhile to install new production capacity in the domestic economy.

Viewing competitiveness in this light shows that there cannot be just one constant value for any economy for the elasticity of demand, for either its imports or exports. On the contrary, the elasticities are bound to change in value as the exchange rate alters. If any economy has an exchange rate which is either very high or very low, relatively small movements in it are unlikely to make much, if any, difference to where it is worth siting most new production facilities. They will be located in the under-valued exchange rate economy and not in the one where it is over-valued. If, on the other hand, considerations are more evenly balanced and a relatively small movement in the exchange rate would tip the balance as to where new production facilities should be located, and thus from where world demand will be met, the sensitivity of total exports to exchange rate changes will be much higher. In other words, the elasticity of demand for exports and imports does not take the form in graphical terms of a straight line. It is more in the form of a bell-shaped curve. The goal in policymaking terms, to get maximum benefit from a devaluation with minimum relative impact on inflation, is then to pitch

the exchange rate at what is estimated to be the highest point on this bell-shaped curve. Where would that be? Calculations not exhibited in this paper but available if required indicate that the level at present would be roughly with £1.00 = $1.00 or about €0.85.

If a devaluation of this magnitude would put the economy in the best position on the elasticity curve, there is then plenty that can be done on the supply side to lift the curve upwards to make the responsiveness of the economy – and hence its price elasticity – greater. We could have major changes made in the availability of finance for manufacturing, flooding potential manufacturers with easy money as was done extremely successfully in Japan after World War II. Local authorities could implement training schemes to make sure that well-qualified labour was available to expanding industry. Planning regulations could be rejigged to make it easy for new manufacturing plants to be established. Infrastructure improvements could be put in place. At national level, trade liberalisation efforts would be much more likely to bear fruit if the economy had competitive exports to offer the world than if they were overpriced. An environment with plenty of new profitable opportunities would attract into manufacturing a whole new generation of entrepreneurs, lifting the average quality of management.

The objective over a transitional period of perhaps five years would be to get the proportion of UK GDP coming from manufacturing up from its current barely 10% to around 15%. It would not need to be so high as the

20% or more achieved in successful economies such as Singapore, Switzerland and Germany – let alone China or South Korea – because they do not have the 5% of GDP services export surplus which we enjoy[45]. If our manufactured exports – currently running at a rate of about £275bn per annum including re-exports[46], rose pro rata with our increased manufacturing output, thus rising by 50%, our export earnings would rise by £275 x 150% to a little over £400bn, an improvement of about £125bn. If one third of this sum was taken up by imports of machinery, raw materials and components, this would improve our balance of payments by potentially about £80bn a year. This would easily bring our foreign payments position into a manageable long-term condition, even allowing for some slippage. If, instead of having a social rate of return of 8% and investment as a percentage of GDP at 17% with an average growth rate of 1.4% per annum – as we have done for the last twelve years – we had an average social rate of return of 14% with 25% of our GDP devoted to investment, we would have had an average growth rate of 3.5% a year.

Once policies along these lines had raised the growth rate and very substantially reduced the constraints on expansion currently presented by our balance of payments deficit, it is easy to see how our other imbalances could be addressed. Much more economic activity outside London and the South East, would go a long way towards reversing the current increases in regional disparities in income and wealth. Reindustri-

alisation would raise productivity, provide better job prospects where they are most needed and relieve our balance of payments constraints. This, in turn, would take away the reason why the government has to run the economy with a large borrowing requirement. We would no longer need Quantitative Easing to sustain and stimulate the economy as the impetus for doing this would shift away from consumption to net trade and investment. Better economic performance all round would greatly improve the work, training and housing prospects for younger people as more investment provided resources for residential construction. It would be considerably easier to introduce measures to make inequality of wealth and life chances less extreme if the economy was doing well and it would make the country more content if almost everyone was enjoying rising living standards. Why, then is there so much resistance to adopting these kinds of policies? It is because no programme of this sort is without risks and problems, some more real and serious than others, and these all need to be addressed.

Problems

The problems which need to be overcome to get the UK economy to grow at more than twice its current speed fall into number of categories. Some are relatively easy to dismiss; some are real and need carefully considered solutions; and some, particularly potential increase in inflation, need be carefully managed to minimise their deleterious impact.

Obstacles which are not likely to cause serious difficulties include the risk of retaliation, a lower pound making us all poorer, and discovering that a much lower exchange rate does not make any difference because there are no UK entrepreneurs willing to come forward to take advantage of new profitable manufacturing opportunities. On retaliation, the UK manifestly has an unsustainable balance of payments problem and, in the end, there is no other solution than a lower pound. The chances of retaliation taking place, therefore, are much less than they would be if we were in a stronger international financial position. There was no retaliation when we came out of the Exchange Rate Mechanism in 1992 and sterling fell by about 15% against the dollar and about the same on a trade weighted basis[47], nor when sterling fell from about $2.00 to the pound to $1.50 between 2007 and 2009.[48] We do have obligations to the G7 not to go in for competitive devaluation but, bearing in mind the size of our deficits, these should be manageable especially if we continue running a small deficit instead of a surplus.

The argument that we make ourselves poorer by devaluing is true if the UK GDP is measured in US dollars, but this is irrelevant because UK shoppers almost exclusively spend pounds instead of foreign currency. If, because of a lower pound, the economy expands faster than it otherwise would have done, GDP per head must go up, so there is an important illogicality to the impoverishment case. It is true, however, that a lower pound and a smaller balance of payments deficit would make most people worse off a least temporarily, probably in the

form of prices rising faster than disposable incomes, unless countervailing action is taken. It is important that this should be done, as is explained below.

As to the argument that the UK is no good at manufacturing and ought not to try to rebalance our economy towards industry, there is no evidence whatsoever that the UK lacks entrepreneurial people who would be willing to take advantage of opportunities for making money out of reindustrialisation provided it was clear that the required conditions were there to stay. The notion that the nation which invented the Industrial Revolution completely lacks people who will respond positively to the same economic incentives that have led to industrial success all over the world is just not credible.

A more serious problem is how to engineer a sterling depreciation by as much as about 25% from its present level of about $1.30 to the pound[49]. We have, of course experienced devaluations of this order in the past – for example, when we came off the Gold Standard in 1931, devaluing by 28% against the US dollar and by about 25% against all currencies[50] and by 22% on a trade-weighted basis between 2007 and 2009[51] and by a lesser amount – 15% – when we came out of the ERM[52]. All these events, however, were very largely market driven, without much initiative from the government.

This time the government would have to be much more proactive. It would have to announce an exchange rate target and to convince everyone of its determination

to maintain it. The Bank of England would need to be charged with running monetary and interest rate policies consistent with this objective, with a mandate to intervene in the foreign exchange market – if necessary by selling sterling on a major scale – to keep the exchange rate where it needed to be. These moves could be reinforced by taking action to bring down the capital inflows which have driven the pound up to its present over-valued condition. This could be done by discouraging the sale of UK assets to foreign buyers, for example by introducing a considerably tougher public interest hurdle for foreign take-overs of UK companies, and by discouraging the purchase from abroad of UK property assets. The strongest evidence that all this would be possible is provided by the many successful countries, such as Singapore, Germany, China, South Korea and Switzerland all of which – with far less justification than in the UK's case – have kept their exchange rates where they wanted them to be, to ensure that they remained competitive.

Another serious problem is that to increase the proportion of GDP going to investment instead of consumption must potentially put a squeeze on household expenditure. If we need to switch about 4% of GDP to high-powered investment to raise the growth rate by 2% per annum, and we need to match this with a comparable increase in social and private investment with much lower social rates of return, this will mean raising total investment as a percentage of GDP by some 8% – from 16% or 17% to around 25%. This produces a problem with three

overlapping dimensions. There would be a requirement for a real resource shift from consumption to investment; there would be a need for saving across the economy to increase by 8% as a percentage of GDP; and the money to pay for much larger volumes of investment would need to be available.

The challenges flowing from the need to increase investment are substantial. It is, however, crucial that they are overcome, otherwise we will never get the UK economy to grow at reasonable speed. The transition to another 8% of GDP going to investment would have to be phased over a period of perhaps five years. The increase in saving could be spread roughly equally across the four main sectors of the economy – the government, corporations, households and – at least temporarily – the foreign payment balance. Perhaps the most crucial problem over the transition to faster growth, entailing so much more expenditure on investment, would be the need to avoid depressing household expenditure as this process takes place. The solution here, especially at the beginning of the transition, has to be to concentrate as much as possible of increased investment in the types most likely to produce high rates of return quickly – and at least initially to give this top priority over increases in investment with lower rates of return. Careful calculations show that avoiding depressing consumer expenditure in absolute terms should just be possible provided that the annual increase in GDP was sufficient to offset the reduction in the percentage of GDP going to investment rather than consumption.

Inflation

Perhaps the greatest concern which most people would have about the strategy set out above is that a deliberate devaluation on the scale proposed would trigger off an inflationary spiral.

Year of Devaluation	Overall Devaluation Percentage	Inflation Previous Year	Inflation Devaluation Year	Inflation Devaluation Year +1	Inflation Devaluation Year +2	Inflation Devaluation Year +3
1931	25%	-1.7%	-10.1%	-9.9%	-6.6%	+5.5%
1949	31%	-5.1%	-2.4%	2.7%	9.9%	6.3%
1967	16%	-3.9%	-2.7%	4.8%	5.4%	6.3%
1992	15%	-5.9%	-3.7%	1.6%	2.5%	3.4%
2008	22%	-2.3%	-3.6%	2.2%	3.3%	4.5%
2016	9%	-0.1%	-1.3%	2.6%	2.4%	

Sources: *One Hundred Years of Economic Statistics* by Thelma Liesner. London: Facts on File and the Economist, 1989, and successive editions of *International Statistics Yearbook. Washington DC, IMF.* Combined with data from the Office for National Statistics and https//inflationdata.com

This might both depress incomes and potentially negate any initial increase in competitiveness which had been achieved, leaving us as no better off in growth terms than we were before but with a worse inflationary problem. These fears, however, are very unlikely to be well-founded. The table above shows what happened to inflation after all the major downward movements in sterling since we came off the Gold Standard in 1931. Despite the inevitable rise in the price of imported goods and services, there is little evidence of overall inflation being a serious problem. This is because, while the rise in import costs pushes up the price level, other factors associated with a devaluation tend to bring it down. Taxation and interest rates tend to be lower; production

runs are longer thus reducing costs; domestic sources of supply take over from those abroad as local production becomes more competitive; and if the economy expands more rapidly the wage negotiation climate improves. When, from our historical experience, inflation did rise at all significantly after devaluations, there were clearly other factors involved, such as rearmament around 1950 and the rash of strikes which erupted in 1968, which pushed up inflation independently of anything to do with changes in the exchange rate. In general, to an extent which may be surprising to many people, it appears that devaluations over all have relatively little impact on changing the rate of inflation from what would have happened anyway. The UK experience is mirrored by similar outcomes where devaluations have taken place in other developed countries.

Even if there was a relatively small increase in inflation, however, most people might well be prepared to accept this as a price to pay for much faster growth. In the end it is the standard, not the cost of living which counts. Crucially, however, the figures in the table – or those from international experience elsewhere – show no evidence at all that increased competitiveness secured by a lower exchange rate will automatically be eroded away by higher inflation than would otherwise have occurred. There are simply no examples of this to be found in the history of any of the reasonably competently run economies in the world. If making our economy more competitive is the secret to getting it to perform better, there is no evidence at all that policies to

achieve this objective will inevitably be invalidated by excess inflation caused by the exchange rate deliberately being brought down.

Conclusion

No major policy change is without risk and the proposals set out above share this condition. The evidence suggests, however, that the risks entailed in using a more competitive exchange rate to trigger faster growth would be a good deal lower than most people expect. The success of the Competitive Exchange Rate Strategy outlined above in the end depends, apart from inflation not being excessive, on only two major variables having roughly the right values. One is the social rate of return which can reasonably be expected to materialise from the most productive forms of investment, especially at the margin. It needs to be in the region of 50% per annum, and there is plenty of evidence to suggest that this is achievable. The second key metric is the responsiveness of exports and imports to a lower exchange rate. Given the right circumstances, would this be large enough to carry the costs of a transition to the much higher levels of investment which are the key to longer term sustained growth? Again, the evidence is strongly in favour of this condition being met, especially if policy steps are taken to reinforce the attractions of exploiting the trading opportunities created by a more competitive economy. Of course, it is also a key requirement that rising inflation does not derail the prospects for much better performance and the risks in this regard also appear to be low enough

to be borne with equanimity. A key conclusion is that all these three key metrics – the social rate of return, the elasticity of demand for import and exports and the rate of inflation – involve variable non-linear responses to policy inputs. And all of them can be manipulated by the government to give stronger positive feed-back by the adoption of policies designed specifically to support their impact on getting the economy to perform better.

The relatively low risks associated with this strategy need to be compared to what is likely to happen if the UK continues for another decade or more with no real wages increase for most people while the rich get richer, disparities between London and the rest of the country widen and a whole generation is deprived of the job opportunities and housing prospects which their parents enjoyed. Sometimes risks are worth taking – and adoption of the Competitive Exchange Rate Strategy outlined above looks like being one of them.

Endnotes

1 www.worldometer.info website
2 ONS code IKBJ. ONS Dataset published September 2018. London: ONS
3 ONS code NPQT as a percentage of YBHA. London: ONS 2018
4 Page 829 in International Statistics Yearbook 2017. Washington DC: IMF, 2017
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10 Table J.1 in Economic Statistics 1900–1983 by Thelma Liesner. London: The Economist 1985
11 Ibid, Table US.1
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13 Calculated from tables in International Statistics Yearbook 2017. Washington DC: IMF 2017
14 Ibid
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22 www.economicshelp.org/blog/7617/economics
23 Calculations based on ONS codes ABMI and YBEX. London: ONS, December 2017
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40 Table 224 in House building permanent dwellings completed by tenure historical calendar year series. London: ONS, 2015
41 Ibid,
42 BETA house Price Index
43 FTSE 100 Historical Data
44 Distribution of total wealth for Great Britain and London (July 2010-June 2014). London: ONS, 2015.
45 Country tables in International Monetary Statistics Yearbook 2017. Washington DC: IMF, 2017
46 ONS codes BQAV and BQBU. London: ONS, 2018
47 Page 981 in International Monetary Statistics Yearbook 2000. Washington DC: IMF, 2000.
48 Page 745 in International Monetary Statistics Yearbook 2010. Washington DC: IMF, 2010.
49 The US$/sterling exchange rate was £1.00 = $1,33 in June 2018. Bloomberg website.
50 Table UK.15 in Economic Statistics 1900-1983 by Thelma Liesner. London The Economist 1985
51 Page 745 in International Monetary Statistics Yearbook 2010. Washington DC: IMF, 2010.
52 Page 981 in International Monetary Statistics Yearbook 2000. Washington DC: IMF, 2000

There is a pressing need to get the UK's economic growth rate up – and not just because most people clearly want this to happen. Failure to achieve this goal also has numerous other undesirable consequences. It promotes widening divisions in the country. It undermines trust in our political leadership. It reduces our status in the world. And it leaves support for the liberal democracy which underpins our way of life increasingly under threat.

In the face of these problems, this pamphlet argues that radical changes are needed to our economic policies. In particular, we need to increase the proportion of our national income that we devote to investment projects, particularly those which generate big increases in productivity. To do this, we need a lower exchange rate to make these types of investment as profitable as possible and the UK much more internationally competitive. Reversing deindustrialisation is the only way to enable us to pay our way in the world and to avoid us being dragged down by our current huge balance of payments deficits.

No major policy changes are without risk and the proposals in this pamphlet share this caveat. The evidence presented, however, suggests that the macroeconomic changes needed to trigger much faster economic growth are a good deal less risky than than is generally supposed – and the consequences of not making them much worse than leaving policies as they are.

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