CIVITAS

ISSUE 1
NOVEMBER 2012

ideas for economic growth

This is the first in a series of short papers discussing how we can encourage economic growth and overcome our debt problem. The author argues that for too long policy makers have neglected the exchange rate. No country can come close to exerting complete control of its exchange rate, but this does not mean that policy makers are powerless. Ignoring the exchange rate can easily wipe out the efforts of companies to remain competitive. A producer may shave 10% off its export price by investing in new equipment and using its skilled workforce wisely, but fluctuations in the exchange rate can easily eradicate all such productivity gains. And if the pound is allowed to remain too strong for a prolonged period, it can become impossible for manufacturers to stay in business at all.

Is the pound over-valued? Why it matters.

John Mills

There was a time not so very long ago – during the quarter of a century after World War II – when Britain had constant balance of payment crises. This focused policy makers' attention on whether the value of the pound was getting unmanageably high, although it did not stop the policy preference for keeping the value of the pound as high as possible that has prevailed at least since the nineteenth century. There was, however, recognition that the exchange rate mattered in 1949 when the value of the pound dropped from $4.03 to $2.80 and then again in 1967 when it fell to $2.40.

Since the break-up of the Bretton Woods fixed exchange rate system in 1971, the pound has floated. There is not the same crisis atmosphere with a floating rate as there is when a fixed rate comes under pressure. Instead, the rate just falls. Primarily as a result of this, policy makers have taken their eye off the exchange rate as being a major factor of concern when shaping economic policy. The mentality seems to be that, if there is no crisis in the offing, and the exchange rate can apparently be left to find its own level as a result of market forces, why worry about it?

There are powerful interests in the City who almost invariably favour a high exchange rate; millions of people take holidays abroad and like getting plenty of foreign currency for their pounds; and almost everyone is worried that a weakening pound will add to inflation, so why not keep the pound as strong as possible? Who, in any event, wants a devalued currency? Who wants to see a national symbol such as the pound going down rather than up? Who indeed wants to defy the strongly ingrained attitudes, reflected vividly in the language used, which takes it as axiomatic that a currency which is 'strong' must be better than one which is 'weak'?

The answer is almost nobody. Unfortunately, however, this is intrinsically related to why our economy is in the condition it is currently in.

The exchange rate as a prism

This is because the exchange rate can be viewed as a prism. All the costs incurred in producing goods and services sold to the rest of the world are refracted through the exchange rate to produce export prices. If the currency is kept as strong as possible on the foreign exchanges, export prices tend to be high compared to those of other exporting countries. If it is weak, the reverse applies. The effect of keeping the exchange rate high, therefore, is to make it much more difficult for manufacturers to export and much easier for the domestic market to be flooded with imports rather than home-produced goods. Long periods of time with an exchange rate which is too high to give manufacturers a reasonable chance to compete in world markets thus tend to lead to progressive deindustrialisation.

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This is highly significant because diverse developed countries such as Britain depend hugely on exports of manufactures to pay their way in the world. Despite the fact that only 8.5 per cent of the UK's workforce is currently employed in manufacturing – producing 12 per cent of national output – well over half of our export earnings are goods rather than services.[1] Unfortunately, this generates nothing like sufficient revenue to keep our current account with the rest of the world in balance. We have a deficit of approximately £100 billion a year on manufactured goods, which nets down to an overall current account deficit that has averaged approximately £30 billion a year over the last decade when net revenues from services and transfers and income from abroad are all taken into account.[2]

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The weakness of the UK's manufacturing base is all too easy to highlight by reviewing what has happened to our export performance compared with other countries in recent decades. In 1950, Britain produced one quarter of the world's exports. By 1970, this proportion was down to 6.5 per cent. By 2000 it had fallen to 4.4 per cent and by 2010 it was 2.7 per cent, and this downward trend continues.[3]

Manufacturing decline leads to inequality and unemployment

The weakness of our manufacturing base not only leaves the UK very vulnerable to deficits as a trading nation, but it also has a number of other key negative impacts. Because productivity increases are so much easier to achieve in manufacturing than they are in the service industries, countries with weak manufacturing bases tend to have much slower economic growth rates. They also tend to generate significantly fewer high-quality blue collar jobs, while the collapse of manufacturing operations and the closing of factories in areas previously heavily dependent on industry produce enormous regional disparities in living standards. This is why, in the UK, the South East now has average living standards 20 per cent higher and the North West 20 per cent lower than the national average.[4]

It is on the balance of payments, however, that the effect of deindustrialisation is in many ways most acute. We cannot afford to run our economy at maximum capacity because of the risk that this would suck in an unmanageably large volume of imports, and we cannot afford to let our foreign payments deficit get too large. The cumulative effect of running the economy with too little pressure of demand, however, is to have continually increasing unemployment rates. The claimant count in the UK is currently approximately 2.6 million, including over one million people aged between 16 and 24, but the real number of people not working despite being able and willing to do so if reasonable wages and conditions were available is closer to 5.0 million.[5] This is a staggering waste of resources and a huge tragedy for millions of people whose talents are wasted as they are denied any opportunity to make a contribution to the national income.

Deindustrialisation also has a major impact on the finances of both the government and consumers. Every year in which there is a big balance of payments deficit is another year when payments abroad exceed the income we earn from overseas. The result is a highly deflationary shortage of demand for the output which the economy is capable of producing. The government consequently comes under enormous political pressure to spend more than it generates in revenue from taxation and charges while consumers are encouraged to spend more than they earn in an attempt to fill this gap. The result in both cases is significant increases in borrowing.

There is nothing intrinsically wrong with running up debts if there is every chance that they will eventually be repaid and if, in the meantime, interest costs can be serviced. This is not, however, the condition into which the UK is drifting. Because of all the constraints on expanding the economy as a result of our inability to pay our way in the world, the UK's growth rate has ground to a halt. At the same time, the government in particular is continuing to increase borrowing, not least because the more its expenditure is cut back the worse the economy tends to perform and the lower the tax take and the higher welfare claims become. Rising debt at the same time as static or falling capacity to service or repay is, however, a lethal combination. It is entirely unsustainable.

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The problems with current economic policy

In terms of rectifying this situation, current economic policy in the UK has two main strands. Unfortunately, neither has a realistic chance of overcoming our present problems. The first is to keep inflation low – as close to two per cent as possible – and to hope that this, with the low interest rates which should accompany it, will stimulate the economy into growth. The biggest problem with this strategy is that the policies needed to keep inflation very low are almost exactly the same as those required to keep sterling much too strong, which is why this strategy will never work. It provides all the wrong economic incentives, making manufacturing unprofitable and importing much too attractive. The second policy strand is to try to make the economy more competitive by concentrating on supply-side initiatives such as training schemes, subsidies for favoured economic activities and policies to encourage new high-tech industries. The problem with these sorts of policies is that they do very little, if anything, to make the economy significantly more competitive, while again doing nothing to improve economic incentives where it really matters, which is to make manufacturing and exporting more profitable and importing less so.

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The only answer to our current malaise is, therefore, to bring the exchange rate down to the level which would be needed at least to enable us to reduce significantly the unemployment rate and to get the economy growing again. In my opinion, around 25 per cent devaluation from the current rate would be required to achieve this, i.e. the pound worth approximately $1.20 or €0.85. Because it would take time for manufacturing to become re-established on the scale required it would take a period of two or three years for a policy change along these lines to become fully effective, but all the international trade statistics show that this could be done.

Conventional wisdom says that this strategy would produce more inflation, that UK living standards would fall, that we now have nothing to sell the rest of the world, that other countries would probably retaliate and that no-one is going to be happy with more expensive holidays abroad. The first three of these arguments against implementing these policies are easily refuted. The statistics simply do not bear out any of these contentions. As regards retaliation, our share of world trade is now so small that it does not make that much difference. Holidays abroad would be more expensive but this is a small price to pay for increasing economic growth to three to four per cent and reducing unemployment to perhaps three per cent.

The biggest obstacle to the implementation of this strategy is, actually, none of the conventional objections to a more competitive pound. It is that for many decades now our policy makers have become inured to fighting the wrong battle. Maintaining inflation at approximately two per cent is not, the evidence presented here suggests, the most important economic policy goal. Instead, as I have shown, moving the exchange rate to a level which allows us to compete in the world, and keeping it there, is a much more important economic objective. Without implementing these policies, the UK has little chance of avoiding years of austerity, very high unemployment, mounting inequality and national decline. A competitive pound, on the other hand, will not solve all our economic problems alone, but without it, I argue, no alternative combination of policies will.

Notes

1 National Income and Expenditure Blue Book 2011. London, Office for National Statistics, 2011

2 Page 743 in *International Financial Statistics. Washington DC, IMF 2011*

3 Ibid, page 67

4 Eurostat Report on Regional GDP per Capita. Luxembourg: EU, 2011

5 Quoted on page 15 in an article by Nicola Smith, Head of Economic and Social Affairs at the TUC in *Fabian Review*, London: The Fabian Society, 2011.

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Civitas Wealth of Nations Project

By common consent the UK faces severe economic challenges over the next few years, and the aim of the 'Wealth of Nations' project is to discover how a free people can create prosperity that is widely shared and sustainable. The term 'prosperity' has been chosen over 'economic growth' to emphasise that our objective should be to increase output through sustainable productive enterprise.

The first challenge is to understand the best approach for government. Over the years, nations have adopted a variety of styles of government that can be placed on a continuum ranging from complete control by a central authority – totalitarianism – to a 'free state' – a government committed to conducting its affairs openly so that its rule can be based on consent and whose aim is to facilitate a free life for its people.

The project will examine public policies aimed at building up productive assets by means of the following strategies: maintaining stable money; encouraging a high level of employment; seeking an external trade balance; selective state assistance; counteracting the business cycle to ensure steady economic growth; pursuing a 'fair' distribution of income based on a 'fighting chance'; and upholding social protection that is sufficient but basic, thus leaving room for personal responsibility.

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