SUBMISSION TO THE PRODUCTIVITY COMMISION ON "*SIZING THE PRODUCTIVITY PROBLEM: INTERNATONAL, NATIONAL, REGIONAL AND SECTORAL ASPECTS*" BY JOHN MILLS

Introduction

I am an independent economist and this submission is written in a personal capacity,. although I am Founder of the John Mills Institute for Prosperity. This paper argues that the supply side factors on which respondents to the Productivity Commission have been asked to comment are a long way from being the most relevant in explaining why the UK's productivity record has recently been so poor. The real reason, is that the exchange rate policy – or more accurately the lack of one - pursued by the UK – has been the fundamental cause of our poor productivity and growth performance. Sterling has been and still is much too strong. If this possibility is ignored, a major opportunity to get to the bottom of why our recent record has been so disappointing will have been missed.

Investment

The starting point is to recognise that almost all economic growth - and hence increases in productivity - stem from physical investment and not from the supply side agenda of improved education and training, more patient capital, directing demand to suppliers in the domestic economy, raising the standard of laggards to that of the best managed companies, etc. Investment as a proportion of GDP is far lower in the UK than the world average – about 17% compared to 25% - with much higher ratios still in the Far East. UK investment as a percentage of GDP is so low because the profitability prospects of much of it in the UK – especially when competing with potential investment locations abroad – are so relatively poor. This has happened because the UK's cost base is charged out to the rest of the world at a relatively high rate, so that our export prices for manufactures are generally too high to be competitive. There is insufficient export led demand to stimulate growth, generating low levels of investment in industry and a weaker economy to pay for investment in non-internationally tradable sectors.

The Social Rate of Return

Econometric analysis indicates that in relatively slow growing economies, about the best which can be achieved from supply side policies on their own at increasing overall GDP is about

0.5% per annum. All the remaining economic growth comes from the returns to physical investment. The total – or social – rates of return on physical investment, which include higher wages, better and often cheaper products, stronger profitability, and a more robust tax base, are, however, far from uniform. Most returns – including those from almost all state-sponsored investment in road, rail, schools, hospitals public buildings and housing - has a social rate of return averaging no more than around 5% per annum. The same relatively low level of returns tends to be found in much of the private sector - in office blocks, shopping malls, service sector IT systems and again housing. What potentially produces considerably greater economic growth are the much higher returns achievable on a comparatively narrow range of investment opportunities centred round mechanisation, technology, and the use of power. The returns here can easily be more than 50% per annum. Think of a combine harvester replacing a scythe, a 42-ton truck instead of a wheelbarrow, a new machine which produces, with the same inputs, twice the output of one it replaces, or a computer replacing a slide rule.

Investments in mechanisation, technology and power tend to be found in the private sector, frequently in manufacturing especially light industry, and often in an internationally tradable environment and thus subject to strong international competition. Investment, especially in the key high return categories, will only happen - because it has to take place in a private sector environment - if it has profitable prospects. The problem in the UK is that for a long time this requirement in the case of manufacturing investment has widely not been fulfilled.

Manufacturing

Evidence that UK manufacturing has a long record of struggling to compete internationally is all too readily available. By some measures, as much as 25% of all world manufactured exports came from UK factories in 1950. Now the ratio is about 2%. As late as 1970, almost a third of UK GDP came from manufacturing Now it is about 9%. This is the main reason why so many of the towns and cities in the UK have far too little to sell to the rest of the world to pay their way. Their living standards are maintained because of very large-scale transfers and subsidies from the more prosperous areas of the economy, especially London. On the latest figures available, - from 2017 – average gross value added per head of the population in London was £44k whereas in Wales and the North East it was £20k.

The lack of modern manufacturing capacity in the UK to replace more traditional industry has had multiple undesirable consequences. Low levels of investment mean that we have missed out on productivity improvements which could otherwise have been obtained. It means that millions of good steady high value-added and satisfying jobs have been lost. It has produced the enormous regional imbalances from which he UK economy suffers so badly. It leaves the UK economy with insufficient to sell abroad, leaving us with a chronic balance of payments

deficit as we rely on the rest of the world to lend us the money required to enable us to maintain living standards which we are not earning.

The UK economy does well on services with our service export surplus averaging about 5% of GDP recently, but services are relatively difficult to sell abroad. They comprise over 80% of our GDP but contribute only 45% of our exports – the same total as manufacturing achieves from less than 10% of GDP. These figures suggest that we will never get our economy rebalanced until we restore manufacturing as a percentage of GDP to around 15%.

If we could shift 4% of our GDP out of consumption and into investment with a social rate of return averaging 50% we could increase our growth rate by 4% x 0.5,, which is 2% per annum. This is the sort of target at which we ought to be aiming.

Competitiveness

The key to economic growth is competitiveness, especially for manufactured exports. International trade in manufacturers is very price sensitive. If any economy has export prices which are lower than the world average, it will tend to gain share of world trade. The stimulus thus achieved from exports generates demand for more investment which in turn stimulates greater competitiveness, larger productivity gains and a faster rate of economic growth and rising riving standards. There is therefore a very high correlation between countries which are gaining share of world trade and those which are growing faster than the world average.

The converse is also the case, and this is the key problem from which the UK has suffered. Because we have allowed ourselves to lose share of world trade and we have accepted the deindustrialisation which has been the inevitable consequence, we have locked ourselves into growing more slowly than the world average. The inevitable consequence has been slow productivity growth.

The Cost Base

A key insight is to appreciate the relationship there is between competitiveness and the exchange rate. ONS figures show that on average in manufacturing about 30% of total costs are made up of raw materials, machinery, and components, for which there are world prices, which are more or less uniform all over the globe. The remaining 70% of costs are almost all incurred in the domestic currency, covering wages and salaries, all overhead costs, interest and taxation. Measured in world currencies, such as the US dollar, the costs of machinery, raw materials and components stay the same whatever happens to the exchange rate. The rate at which all the domestically incurred costs are charged out to rest of the world, however, is determined very largely by the parity of the domestic currency in world markets.

The significance of this situation is borne out when considering examples of exchange rate changes which have taken place in the relatively recent past. Between 1977 and 1982, according to IMF data, the real effective exchange rate – the most comprehensive and accurate way of measuring export competitiveness - increased for sterling from an index number of 76.4 in 1977 to131.8 in 1982, a rise of 73%. If export prices were 100 in 1977 this means that by 1982, they had to be 30 + (70 x 1.73), which is approximately 150 - an increase of 50%. - to maintain the same margins. By contrast, between 1980 and 1993, the equivalent index number for China fell from 367 to 86, a reduction of 77%. If China's export prices in 1980 were 100, this allowed the Chinese to sell their goods abroad at 30 + (70 x 0.23), which is close to 50 as a result of their much lower exchange rate – i.e., at about half their previous price and without any percentage margin sacrifice. While the UK's investment as a proportion of GDP then fell, the Chinese ratio soared. While the UK's growth rate stagnated, China saw its GDP doubling roughly every seven years decade after decade. In 1980, average Chinese living standards were barely two and a half times what they had been in Europe during the Dark Ages following the collapse of the Roman Empire. By 2020, Chinese GDP per head was close to 40 times what it had been in 1980. No doubt other factors were involved but it is impossible to believe that hugely contrasting UK and Chinese exchange rate policies have not played a very major role in determining the very different economic performances of the UK and Chinese economies over the past 40 years.

Why is Sterling so Strong?

Except for a short period in the 1930s, following the 1931 devaluation, sterling has always been too strong for UK manufacturing. The UK economy was pre-eminent in the nineteenth century but only because of its industrialisation first-mover status. It began to lose out to competitors as soon as other countries started to industrialise. The UK sustained much more inflation during World War I and II than the USA but insisted on keeping the rate against the US dollar as close as possible to what it had been before the start of hostilities. When monetarism and neoliberalism became the mainstream economic doctrines, very high interest rates were used by the authorities to squeeze down inflation apparently with hardly a thought for what this would do to our export competitiveness.

The public like a strong pound because this provides cheap holidays abroad and low prices for goods in our stores. A high value for sterling gives the financial community more international leverage. Services can manage with a high exchange rate. They are much less price sensitive than manufacturing and we have natural advantages in our language, our geography, our legal system, our universities, and the skills of our labour force, which provide them with major competitive advantages. To get the parity to be competitive enough to push

the growth rate up to say, 3% per annum, however, we need the productivity gains which only manufacturing is capable of achieving. For this outcome we need roughly parity between the pound and the US dollar, but we are miles away from this. On the contrary, the result of all the pressure in favour of a strong currency is that it is now barely respectable even to consider whether we should have an exchange rate policy at all rather than treating the exchange rate parity as a market driven residual largely outside government control.

The cost of having too strong a currency, however, is prodigious. It depresses investment. It emasculates manufacturing, draining talent out of industry in the process. It has left large areas of the UK with no viable economic base. It means that we forego the productivity improvements which are the only sure route to higher output per hour, faster economic growth, and rising living standards.

Objections

There are six standard objections to implementing a competitive exchange rate policy, none of which bears much if any significant weight. Taken in turn:

1. Plenty of historical experience shows that devaluations are much less inflationary than is often supposed. For example, UK price rises fell sharply after we left the Exchange Rate Mechanism in 1992.
2. The risk of retaliation is low. as we saw when the value of the pound fell between 2007 and 2009 by 25%.
3. This happened without there being any breaches of our international obligations to maintain freedom of capital movements.
4. A lower exchange rate does not make us all poorer. II cannot do so if the result is a larger economy stemming from faster economic growth.
5. Past devaluations, far from making our economic condition more difficult, have invariably led to better outcomes than would otherwise have materialised.
6. There is no evidence at all that UK entrepreneurs would not respond positively to new opportunities for making money if the prospects particularly for manufacturing industry were radically improved.

Changing the Exchange Rate

Would it be possible to get the sterling exchange rate down to a much lower level? If the authorities were determined to get this done, they could certainly do so as Japan has recently shown as the yen was devalued by 35% between 2011 and 2014. Our current deficit can only be financed by money coming into the UK from abroad and we could make this more difficult by, for example, having a public interest test on takeovers from abroad. We could run a large

wealth fund to use sterling to buy up foreign assets. We could implement a withholding tax. We could instruct the Bank of England to use its international buying and selling operations to maintain a much lower exchange rate. There is nothing new about any of these approaches. They are what many countries throughout the world do on a constant basis to make sure that their exports remain competitive. Because we have our own central bank and our own currency, all of this is possible for the UK.

It should not be our objective to run a balance of payments surplus, thus helping to help to destabilise the world economy, as too many nations, such as Germany, Switzerland, Singapore, and Saudi Arabia, have done. On the contrary, it would be in our interest to run a small deficit, not least to help to keep the exchange rate down. If we had a lower exchange rate, we would be able to supply the rest of the world with goods at better prices and if our economy grew more rapidly, we would be a bigger market for the world's exports.

Lowering the UK's exchange rate would inevitably cause political and technical problems, which would have to be weighed in the balance against the huge advantages of the UK – and indeed the rest of the world too – in having the UK economy in better shape. The major obstacles in the way are not technical. It is the unwillingness of our policy makers at present apparently even to consider an active exchange rate policy approach.

The Supply Side

None of these arguments is intended to downplay the importance of the supply side issues on which the Productivity Commission will no doubt have much to say. Improving productivity and getting the economy to grow faster may depend on increasing investment in mechanician, technology and the use of power but it also needs the complementary benefits obtainable from more socially orientated investment in both the public and the private sectors. Of course, we need better education and training; more patient capital, improved infrastructure and investment in roads, rail, schools, hospitals, and housing as well as more investment in the service sector.

The key issue, however, is to recognise the need for concentration on the demand as well as the supply side components of the reforms which need to be implemented. We need the stimulus for investment and growth from export led demand to provide both the resources and the rationale for all the supply side improvements in performance which we need to achieve, based mainly on a manufacturing revival but with due weight given to the importance of investment mainly undertaken for social reasons.

Conclusion

The UK is facing a very critical period. There is a major risk that our economy is hardly going to grow at all once the bounce back from Covid -19 has been banked This is because our rate of investment is too low and too directed towards projects with low social rates of return, risking a period of near or possibly even complete stagnation. This is all too likely to happen at the same time as increased costs on climate change, health care, social care, pensions and training cut sharply into disposable incomes, potentially entailing large and sustained cuts in living standards. The only way to stop this happening is to increase productivity, and the only realistic route to getting this done is radically to increase the UK's expenditure on investment as a percentage of GDP, particularly physical investment on mechanisation, technology, and the use of power.

The key to getting investment up, especially in the key high social rate of return areas, is to make it profitable and this is very largely an exchange rate issue. The Productivity Commission therefore has a choice. It can ignore the exchange rate in which case there is a large risk that a huge expenditure of effort will finish up by achieving little of any real of consequence. Or the Commission can put the exchange rate on its agenda and engage with the arguments set out in this paper. This would then open up the prospect of a radical change in policy being considered which could lead to the UK economy growing much faster – perhaps at 3% or even 4% per annum - on a sustained and sustainable basis.

Which way will the Productivity Commission decide to go?

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