a competitive pound

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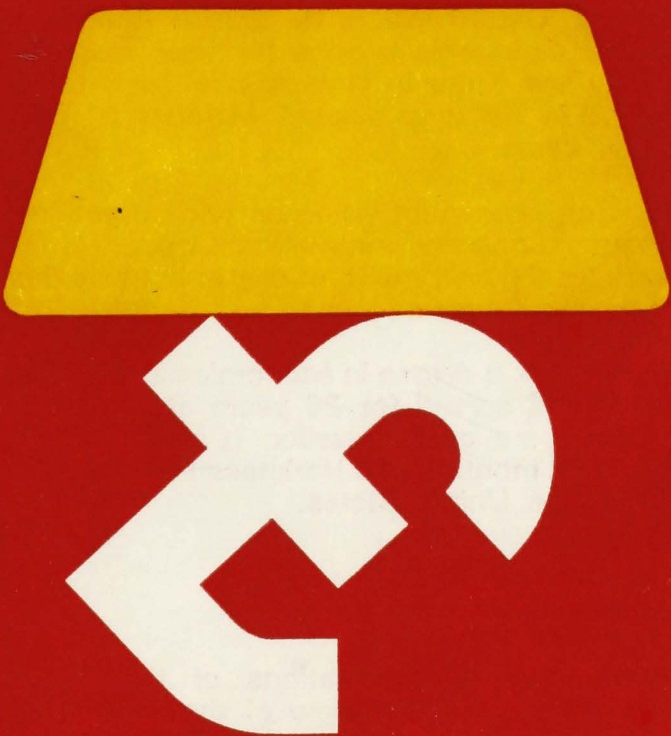

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1. the truth about sterling

You shall not press down upon the brow of labour this crown of thorns, you shall not crucify mankind upon a cross of gold " William Jennings Bryan, Democratic Convention, 1896.

" I would rather see Finance less proud and Industry more content " Winston Churchill, 1925.

The Prime Minister was widely applauded when, in his address to the Labour Party Conference in October 1976, he committed the Government in no uncertain terms to a policy for the regeneration of British industry through export led growth. This commitment was repeatedly and enthusiastically endorsed by the Chancellor of the Exchequer, who rightly pointed out that any other form of growth would lead us back to the structural and balance of payments problems which have bedevilled us for decades. It seemed that at long last a new start had been made, when in December 1976 the IMF insisted as a condition of their $3.9 billion standby credit that the Government would manage the exchange rate so as to maintain the competitive position of British industry at home and overseas, while at the same time placing a limit on domestic credit expansion in terms which do not allow for any form of growth which is not export led. This set the IMF's seal of approval on the Government's policy and assured its achievement by setting the value of sterling at the right level.

The thesis of this pamphlet is that the Government have broken their undertaking to maintain the competitive position of British industry at home and abroad by letting the value of sterling rise by nearly 10 per cent against the dollar although our prices have risen 1 per cent faster each month than those of our principal competitors and that as a result their overzealous observance of the parallel undertaking to limit domestic credit expansion has substantially increased the level of unemployment; that this is merely the latest instalment in an exchange rate policy which has been the root cause of our difficulties since the war; and that in the absence of a competitive exchange rate all other efforts to improve our economic performance are bound to fail.

If we are to achieve that combination of internal economic expansion and external equilibrium which is usually described as export led growth, the exchange rate must enable us to sell abroad at a price which is both competitive and profitable. Whatever else we may do, we shall not achieve sustainable growth unless this necessary but by no means sufficient precondition is met. If our export prices are not competitive, there will be insufficient demand abroad for our goods to provide a stimulus to economic activity through expanding export markets and it will be much more difficult to resist import penetration. If the exchange rate does not allow us to sell abroad at a competitive price which is at the same time more profitable than the home market price, manufacturers will turn back to the easier home market as soon as home demand rises and we shall run into our familiar balance of payments problem. Nor is it enough that this conjunction of competitiveness and profitability in export markets should be temporary. We need an assurance that exporting will be set on a course of expansion and profitability so that investment in new capacity for export production will be encouraged.

Many people regarded it as axiomatic until recently that sterling's fall in 1976 must have made our exports competitive. They steadfastly refused to recognise the fact that last year's depreciation did no more than, and probably not enough to, keep pace with our loss of international competitiveness. The belief that the rapid fall in the exchange rate in 1976 had given us all the advantages of a competitive exchange rate persuaded the Government to use nearly $3000 million out of our meagre reserves in 1976 to prop up sterling and to raise interest rates to a damaging high level. It was these mistaken policies, rather than anything to do with the public sector deficit, which forced us into the hands of the international bankers, who insisted on monetary policies which could only impoverish us by increasing unemployment, on cuts in public expenditure regardless of the merits of the case in terms of the utilisation of real resources, and on the sale of a large part of the public stake in British Petroleum. All this was contrary to everything the Labour Party stands for in government and the Cabinet was persuaded to agree to it only because the Chancellor, backed by the Prime Minister, insisted that our exports were already fully competitive on price and that, because of the adverse effect on the cost of living, the alternative of letting the pound fall could only be damaging. All concerned had resolutely refused to look at the facts.

export competitiveness

There was as we shall see a good deal of evidence, for those who cared to look for it, that the Chancellor had been wrongly advised when he claimed in his New Year 1977 message to the *Financial Times* that our exports were more profitable and more competitive in price than they had been for many years. Indeed, the Government's own index of comparative export prices for manufacturers (the Index of Competitiveness) showed that we were less competitive in each of the first three quarters of 1976 than in any quarter from June 1973 to April 1975.

This index—reproduced in the appendix—shows that our competitiveness had been declining at an unprecedented rate for a least two decades. There was an improvement, but only to the 1961 level, following the 1967 devaluation, but by early 1972 the position was even worse than it had been in 1967, largely because the Bank of England had wiped out most of the benefit we had obtained from the devaluation by raising the price of sterling against the dollar at a time when our unit costs were rising much faster than those of our competitors. Our competitiveness improved very substantially after sterling was allowed to float in June 1972—the pound fell from a high of \$2.66 in April 1972 to a low of \$2.28 in the first quarter of 1974—but in the second quarter of 1974 and again in the second quarter of 1975 the Bank intervened to raise the rate and in doing so made sure that imports would continue to increase much faster than exports. Our competitive position had clearly deteriorated a good deal by the first quarter of 1976 as a result of our higher rate of inflation and, as the index shows, the fall in the exchange rate in the first nine months of the year did no more than make up for the ground lost since the middle of 1975. There was an improvement in October and November 1976, when sterling at one stage fell to a low of \$1.55, but it was short lived and by the end of the year all the ground gained had been lost.

The policy for the first half of 1977 of holding the rate steady against the dollar at \$1.72, even though our costs were rising much faster than those of our competitors, made our exports daily less competitive and the policy at the time of writing of allowing the pound to rise against the dollar at a time when other countries are devaluing is bound to exacerbate the problem. We estimate that, despite a significant increase in the value of the mark and the yen in the first half of the year, the index of competitiveness had risen to 97.6 in the first quarter and a little higher still in the second. The position may be contained for a few months if the Germans and Japanese continue to respond to pressure from the USA by letting their currencies rise against the dollar, but the fact is that in terms of the index we are already in a worse position than in any year since 1972.

statistical evidence

The Index of Competitiveness is in our view the most reliable of the six indicators which the Treasury use to assess our international competitiveness, based as it is on comparative export prices for manufactures expressed in dollar terms. The terms of trade can tell us a great deal about what is happening in our home market and by implication in overseas markets, but although the figures are available at least six months earlier and although all but one of their other indicators suffer from the same defect, the Treasury do not take account of changes in the terms of trade on the grounds that imports and exports are not competing in the *same* market. International comparisons of unit labour costs, wholesale prices, purchasing power and export prices in general cannot, for reasons which are touched on in chapter three, in any case accurately measure our competitiveness in that part of industry which is actually in the business of exporting. Comparative export prices in general—which are unfortunately still used by many financial journalists—have the particular disadvantage that they include foodstuffs and therefore understate the extent to which our manufacturers' export prices have risen compared to those of the US and France since 1973.

The Index of Competitiveness, though damning enough, nevertheless greatly understates the real deterioration in our position over the years. First, it takes no account of the goods which we have stopped exporting because they were priced out of the market. The same problem arises in the case of other countries, but it is more significant in our case because our share of world trade has fallen far more than that of any other country. It is significant, for example, that the old export price index, based on 1963, shows that our export prices relative to those of our competitors increased 3 per cent between 1965 and 1972 whereas the 1970 index shows no change. Secondly, an index based on export prices cannot take account of the price advantage we enjoyed in many markets in the 1950s as a result of quantitative restrictions on imports from the dollar area and Japan, or as a result of tariff preferences in the Commonwealth, the Irish Republic and EFTA before we joined the Common Market. The public were repeatedly told during the debate on EEC membership that our tariff preferences did not matter, but a Board of Trade survey in 1965 showed that our preferences in the Commonwealth were worth 7 per cent overall and worth 12 per cent on the goods directly affected. Indeed, the Treasury seems to have completely ignored tariff changes in deciding the level of the exchange rate. In particular little attention was paid to the likelihood that the elimination of tariffs between the UK and the EEC Six would be of greater benefit to the Six than to us as our tariff was higher than theirs. A study of the effects of the Kennedy Round in the March 1977 issue of the *Economic Journal* supports the view that the Six did not need the whole of their tariff protection to keep out imports and it is significant that whereas our share of the Six's market for manufactures declined fractionally between 1970 and 1976 their share of our market rose from 28 per cent to 48 per cent; furthermore our share of the Danish and Irish markets has declined much more rapidly since we joined the Common Market. Certainly the imbalance of trade with the Six has been greatest in the case of motor cars and steel, where the effective protection conferred by the tariff was very considerable. We estimate that the net loss of protection in our own and other markets on this account could only be compensated for in terms of increased exports by a devaluation of between 5 per cent and 10 per cent, which would reduce the index of competitiveness to 85-90 and the terms of trade to much the same figure. One reason the terms of trade have generally been higher than the index in recent years may indeed be this loss of protection, enabling our competitors to reduce their prices in our market more than we could reduce prices in export markets to meet their competition.

Finally, the index is misleading because our prices were depressed by a severe credit squeeze in 1970, the base year. The exchange rate would have had to be much lower to avoid a flood of imports if the economy had been running in top gear. This is even more true today, with a higher level of unemployment and a greater fall in real incomes.

the terms of trade

The purpose of devaluation is to combine a reduction in the price of exports with an increase in the price of competing imports. This worsening of the terms of trade—worse because more has to be exported to pay for a given quantity of imports—is actually beneficial if the alternative is a loss of employment as a result of import led stagnation. Manufactures now account for nearly 60 per cent of our total imports and industry will not prosper until the price of manufactured imports rises faster than the price of manufactured exports.

The index of terms of trade therefore offers a useful indicator of the effectiveness of changes in the exchange rate. The appendix shows that there is a definite link between movements in the terms of trade and the balance of trade in manufactures. The figures from 1950 to 1960 must be treated with caution because of the Korean War (to which other countries responded by pushing up their prices faster than we did); the effect on trade in steel and machine tools of the years of rearmament which followed (and which almost certainly accounted for the fact that UK imports of manufactures increased much more in price between 1954 and 1956 than the world price of manufactures); the reimposition of controls on UK imports from non sterling countries in 1953-54; the Suez crisis in 1957; and the gradual relaxation of restrictions on imports from the Dollar Area and Japan by other countries as well as the relaxation of our own restrictions on imports from non sterling countries generally.

But even given these reservations it is clear from the figures that the higher the terms of trade the greater the subsequent increase in imports relative to exports. The one exception in fact proves the rule: the improvement in the balance of trade in 1965-66 can be attributed to the surcharge of 15 per cent on imports and the subsidy of 1-3 per cent on exports of manufactures. This should indeed be taken into account in examining the effectiveness of the devaluation which replaced it: the increase in the margin of protection conferred by the devaluation had been almost entirely anticipated and although the loss of the export subsidy was not in itself of any great account it has to be seen alongside the post devaluation increase in the sterling price of imported materials and components. The fall in the terms of trade between the third quarter of 1967 and the fourth quarter of 1969 was nevertheless as much as 13 per cent, when measured on the basis of trade in 1961, though considerably less than this when measured in terms of trade in 1970 (see appendix). The fall was mainly due to the rise in the price of imports immediately following the devaluation and although the import deposit scheme introduced in November 1968 must have affected the volume of imports in 1969 the improvement in the balance of trade in that year must have owed a good deal to the rapid increase in exports after devaluation.

The gain, even if it did no more than stop the rot, was thrown away in 1970-72 when the Bank of England raised the sterling dollar rate from $2.40, where it stood after the devaluation of 1967, to a peak of $2.66 in April 1972. The terms of trade index rose from 88.6 of the 1961 figure in the third quarter of 1969 to 108.8 in the second quarter of 1972, and the effect on the trade balance was as disastrous as it was predictable. When the damage became apparent the rate was allowed to drop to $2.45 in 1973 and $2.34 in 1974, years in which import prices rose faster than export prices. The terms of trade, measured on the 1970 figure, fell to only 91.4 in the first half of 1974, but the action of the Bank in raising the rate of exchange from $2.28 in the first quarter of 1974 to $2.40 in the second and holding it for a year thereafter in the range $2.32-$2.40 raised the terms of trade to around 102 in mid 1975. The rate of exchange was allowed to fall sharply in the second half of 1975, but by that time wages and prices were rising very much faster than those of our competitors and the Bank clearly had no alternative but to let the pound fall. The Treasury statement on 9 April 1976, that there was no economic justification for the reduction in the rate to $1.84 grossly misrepresented the facts of the case. The terms of trade index indeed shows very clearly why we are still suffering from import led stagnation. It fell in the course of 1976 from the high point it reached in the first quarter, but only in the final quarter did it fall by enough to enable us to get below the 1970 figure by even a whisker and it was still much higher than in 1968-69 and higher even than in 1973-74. This year the position is getting steadily worse, as a consequence of the Bank's exchange rate policy. Our difficulties are truly and incredibly of our own making.

There are differences of view about the time lag between changes in the exchange rate (and consequently in the terms of trade index) and the effect on the balance of trade. The Treasury claim that the full effect takes several years, but what matters is how long it takes to feel the main impact and we believe that this is faster than the Treasury care to admit. The figures for individual industries suggest that the response takes about 12 months, but in present circumstances, with most firms hungry for business, we would expect the reaction to be faster than in the early 1970s. What does come through very clearly is the response to changes in price. The crude balance of trade in the case of engineering and vehicles is as low as relative prices are high and unless there is a change in sterling policy these will be the new wastelands of British industry.

export profits

When it became evident in the autumn of 1976 that exports were not increasing as fast as was hoped the Treasury extricated themselves from what could have been a tight corner by arguing that exporters had taken advantage of devaluation to increase their profit margins rather than volume. Their only evidence for such a sweeping assertion was that manufactured export prices had risen much faster since the beginning of the year than the wholesale price of manufactured goods less manufactured food, drink and tobacco, which are not classified as manufactures in the trade returns. Unfortunately even the most reputable financial journalists for many months accepted this as a fact and *Tribune* even ventured into the arena with a demand that the price of exports should be controlled to stop such "profiteering". In practice as well as in economic theory there are few cases in which profits can be maximised by sacrificing volume to price, particularly where a firm is working far below capacity, as most were in the second half of 1976. This should have been a warning signal. What the experts had in any case failed to notice is that export prices had been rising faster than domestic prices for a considerable period. Nobody has ever claimed, for example, that UK exports were very profitable and competitive before the devaluation of 1967, but it is a fact that export prices rose 5 per cent faster than the wholesale price of manufactures (less food) between 1963 and the third quarter of 1967, just before we devalued by 14 per cent. There was in fact every reason to believe from experience that as a result of devaluation exporters would go for an increase in volume rather than increasing prices by more than would be required to give them a reasonable margin of profit on sales. This was certainly the case in 1967 and indeed it gave rise to the widespread view that devaluation initially has an adverse effect on the balance of payments because of the operation of what is known to economists as the "J Curve". Firms which specialise in the production of specialist goods, such as crawler tractors, often do combine high exports with high profitability, especially firms which are subsidiaries of US firms, but such evidence as we have been able to collect suggests that exporting has become less rather than more profitable in recent years. Figures collected by the MEDC from companies reporting in the year ending 31 March 1975, show that of the mainly British controlled firms making a diversified range of engineering products, those which exported at least twice the sector average of 18 per cent of production earned only 7.5 per cent on sales compared to 10.1 per cent earned by those which exported no more than half the average.

It could of course be argued that the exchange rate was nevertheless competitive enough to enable the bad exporters to earn good profits in the UK against foreign competition, but this would ignore the importance of tariff protection in the home market and, more important, the nature of the goods produced by the bad exporters. The point here is that we are being driven more and more into producing goods and more particularly services which cannot be easily traded internationally.

There have been and always will be firms which strike a rich vein of profitability overseas as well as at home, but very few firms reporting in the first half of 1977 on their operations in the second half or even the fourth quarter of 1976, when both export prices and the value of sterling were much lower in dollar terms than at present, were able to tell their shareholders that profit margins on exports had increased as a result of devaluation. The Press has occasionally referred to export successes by particular firms, but almost without exception the increased profit on exports has been at the expense of margins and sometimes even at the expense of both margins and volume. More prominent have been the references to profitable production overseas and the recent decision of ICI to give priority to investment in Germany is an example of a trend to move production out of this country.

other evidence

For those who are suspicious of statistics, even those as coldly compelling as our trade figures, there is other evidence to which we can turn. The Chancellor's Financial Statement of 29 March 1977, forecast an increase in exports of goods and services in both the second half of 1977 and the first half of 1978 of no more than 5½ per cent compared to the previous year. This is less than the forecast increase in world trade and if account is taken of the expected improvement in oil and invisibles it is clear that the Treasury were not expecting much of an increase in exports of manufactures. The forecast of imports of goods and services in each of the two half years provides for an increase of as much as 2 per cent despite the expected fall in imports of oil and the general fall in living standards. The Treasury have in fact had to admit that they foresee both a fall in our share of world trade in manufactures and "some continuing rise in the trend of import penetration for manufactures". No wonder they also forecast rising unemployment and a rate of growth in manufacturing output which is likely to be considerably less than that of our principal competitors. The truth must be that export led growth was never really on the agenda. The National Institute for Economic and Social Research and the London Business School are even more pessimistic about the outlook for exports.

More important is the CBI finding in June 1977 that only 28 per cent of the firms responding to their monthly survey had an export order book above normal compared to 30 per cent with one below normal, and this despite the fact that a far larger number of firms had a total order book below normal than those with one above. This is consistent with the finding in the April 1977 survey that the number of firms which felt that lack of price competitiveness was an inhibiting factor in securing export orders had risen to 56 per cent and was on a rising trend. Indeed, the CBI warn in their latest report on the economic situation, published on 4 July 1977, that what they chose to describe as our "good trading performance" is in danger. They say that the erosion of price competitiveness and pressure on export margins is an insistent theme of reports from the regions; that relative prices of exports rose significantly in the first half of 1977 despite the fact that unit values of manufactured exports rose markedly less fast than domestic wholesale prices of manufactured goods; and that all this suggests that there is now "renewed and serious pressure" on price competitiveness and export profitability.

The CBI attribute this pressure to the relatively high rate of increase in unit labour costs in the UK in comparison with other countries, a trend which they of the sluggish growth of productivity and the still rapid rate of increase in labour costs. They point out that the concern which so many of their members had expressed in April about their competitiveness highlights the importance of relative prices and that the pressure on export margins is likely to have a serious effect on industry's ability to compete in non-price areas.

The measure of the problem can in any case only be fully understood against the background of our steadily declining ability to compete in world markets, as shown in great detail in a special supplement to the Board of Trade Journal of 18 November 1966, which analysed UK and world exports of manufactures over the previous decade, and as shown in convincing terms by the figures in the appendix. Although our share of world trade fell by more than half between 1956 and 1976, this was only the most recent instalment of a decline which had gone on for almost a century. consider particularly worrying because There have in fact been only two years since 1950 when our share of world trade did not fall. In 1971 our share increased by 0.3 per cent to 10.9 per cent. The devaluation of 1973-74, which reduced the index of competitiveness to a low of only 90.7 and the terms of trade index to 93.4 in, respectively, the fourth quarter of 1973 and the first quarter of 1974, undoubtedly benefited our exports in 1975, when our share of world trade rose by 0.5 per cent to 9.3 per cent, but we doubt whether we would have done so well had there not also been a large fall in trade between industrial countries.

There is not much point in congratulating ourselves on being as competitive as we were, say, in 1962 or 1972, when these were years in which we were losing ground. Of course our share of world trade was bound to decline from the peak of well over 30 per cent reached in the last century, but there was no reason why we should have fallen from first to fifth place in the export league with every prospect of falling to sixth in the not too distant future. All our major rivals with the exception of the United States have increased their share over the past 20 years and it is perhaps no coincidence that the United States is the one other major country whose economic policy is effectively controlled in the interests of finance rather than industry.

conclusion

The evidence is therefore overwhelming that our exports have been and still are less competitive and less profitable than is required to promote export led growth of the kind which we were told was essential for the regeneration of British industry. This conclusion is reinforced by the work on competitiveness and trade patterns published in the 1977 *Cambridge Economic Policy Review*, which shows that in 1976 we could only have retained the share of world trade we enjoyed as recently as in 1970 if we had reduced our costs relative to our competitors by 14 per cent more than we did. A similar conclusion was reached by three different routes in an article in the *Journal of Economic Studies* in November 1976, using the Treasury's own formula for the effects of devaluation on the balance of trade in manufactures and taking into account changes in the terms of trade and tariff patterns.

Only when these unpalatable facts are faced will we have any chance of devising policies which really will put a stop to the long process of industrial decline in this country. Until this happens, however, all the talk of export led growth is just that—talk. It is depressing that so few commentators noticed quite how smartly the prospect of export led growth receded in early 1977. It is equally depressing that the Chancellor made no attempt in his budget speech to prepare public and trade union opinion for the fact that, even to prevent our present uncompetitiveness from getting worse, the value of the pound will have to come down. It is the refusal to face facts such as these which is the real British disease and which has contributed so strongly to a trading and industrial decline which has now gone on for over a century.

2. the origins of the British disease

The problems of the British economy today are of long standing. A narrowing of our manufacturing base, a declining share of world trade, failures in productivity and competitiveness, have all been unwelcome features of our economic performances for well over a century.

Many explanations have been offered for this relentless decline, but little attention has been paid to the role of exchange rate management as a determinant both of the general trend and of short term variants within it.

In the first half of the nineteenth century a very high proportion of British investment funds found their way into new manufacturing techniques in British industry and new road, rail and sea communications. In the late 1860s, however, in response to falling profit margins in British industry, there was a big shift from home to foreign investment. This made matters worse, for the more we earned abroad from investment and, later shipping and other invisibles, the less we needed to sell abroad to pay for our imports. Indeed, because our currency was backed by gold, we were actually prevented from selling more overseas than we wanted to import. This was because under the Bank Act of 1844 the note issue was tied to the amount of gold by the Bank of England. If the amount of gold increased as a result of an expansion of exports—which had to be paid for in gold—the amount of currency in circulation would also have to be increased, prices would rise, and sooner or later our exports would be reduced to the level required to restore equilibrium. The only escape for British industry from this trap was through an adverse movement in the terms of trade —requiring more exports for a given volume of imports—or an increase in the rate of capital exports. These two factors in fact combined in 1910-13 to produce a remarkable expansion of British exports. The growing world demand for food and basic materials had forced up prices and triggered off a huge investment boom in the Commonwealth and South America, and the outflow of funds on both current and capital account financed a huge expansion in demand for our exports. Profits and investment in British industry rose very rapidly in consequence.

the turning point

The years 1871-73 were probably the turning point in our industrial history. The huge consumer and investment boom which followed the American civil war and the Franco-Prussian conflict had a dramatic effect on wages and prices, especially in coal mining and heavy industry, and although wages and prices fell sharply when the boom collapsed British industry had undoubtedly lost some of its competitive edge. Exports fell from £256 million in 1872 to £192 million in 1879, and although volume undoubtedly rose as prices fell the 1872 figure was not exceeded until 1890. In the case of manufactures the ground lost was not recovered until 1903—30 years later—and, within the total, the share going to non Empire countries fell from 75 per cent to 63 per cent. Imports of manufactures on the other hand doubled in value and by 1900 imports of finished manufactures from foreign countries actually exceeded the corresponding figure for exports. Germany, the United States and France were all doing much better than we were in third markets, including other developed countries. Our feet were thus firmly set on the road to import led stagnation which we are still doggedly treading.

The picture in the last quarter of the century is a familiar one today. An even higher proportion of investment in the UK went into housing and municipal bonds and less and less into manufacturing. Employers, lacking an expanding market for their goods, were reluctant to spend money on new machinery and wherever possible combined to raise prices and profit margins by restricting trade. Workers similarly combined to keep up wages and to resist any move to reduce manning ratios. The new science based industries were not considered a sound investment and more and more of our talent went into banking, shipping, distribution, colonial administration, the civil service, education and the professions, all offering more money or better status, or both. What made life tolerable for the working class was the continuous reduction in the price of food, leaving them with money to spend on other comforts. The standard of living of the middle classes was likewise rising as a result of increasing income from foreign investments, enabling them to close their eyes to what was happening to British industry and thus to make common cause with the hard money men.

the twentieth century

An opportunity to escape from this trap came when the force of events compelled us to leave the gold standard in 1914. The value of sterling against the dollar fell to $3.66 in 1920 compared to the pre war figure of $4.85. However, instead of taking advantage of the situation to regain the share of world exports we had lost to the United States and Japan during the war, the authorities began to think in terms of a return to the pre war parity as soon as the post war boom collapsed. There was no economic justification for such a move, but those immediately concerned were not in the habit of thinking in economic terms, and this aspect of the matter was given scant, if any, attention. The result was that, despite massive unemployment, the exchange rate was gradually forced up until the pre war level was reached, and at that point the currency with much acclaim was once again tied to gold. The pound could now " look the dollar in the face ". National honour was presumed satisfied, but the effect on our economy was disastrous. Wages and prices fell continuously between 1921 and 1924, but even so our manufactures lost ground at home and overseas, imports rose faster than exports, and unemployment was far higher than in any other industrial country. It never fell below 9.6 per cent in the twenties and we were indeed the only country in an increasingly prosperous world whose economy stagnated during the long boom from 1922 to 1929. The situation was, of course, inherently unstable. The continuing and substantial outflow of long term capital could only be financed by Bank of England intervention in the money market to attract and *hold* short term funds in London. We were thus driven to borrowing short and lending long, the banker's recipe for financial disaster. The 1929-31 Labour Government nevertheless sacrificed every interest of the Labour movement in giving effect to the monetarist policies which were being pressed on them from all sides and which were actually abandoned within a few days of their leaving office.

The new policy of devaluation, protection against imports and tariff preferences within the Commonwealth, in fact proved the right mix in an imperfect world. Industrial production rose much faster in the UK between 1930 and 1937 than in any other industrial country, indeed so much so that, as against every country apart from the United States, we caught up all the ground we had lost in the twenties. We nevertheless ran into increasing difficulties in the late thirties. In January 1934 the dollar was devalued by 41 per cent and in 1936 the Americans were followed by the Gold Bloc countries—Switzerland, Belgium and the Netherlands, led by France. Incredibly, we then agreed to maintain the new rates through the Exchange Equalisation Fund and imports of manufactures once again rose more rapidly than exports. The Economic Commission for Europe estimated in 1948 that sterling was as overvalued in 1938 as it had been in 1929, that is by some 15 per cent.

war and post war

The rate of sterling against the dollar fell after the Munich Agreement and when war broke out was fixed at $4.03. This rate was maintained after the war for far longer than was justified. There was no need for us to reduce our prices in terms of foreign currencies so long as goods were in short supply, the more so because British exporters were more reluctant than their foreign competitors to take advantage of the sellers' market to raise prices much above the domestic level, but in the longer term we had to face the fact that a much higher proportion of our imports had to be financed by exports than had been the case before the war. The United States economy had also been greatly strengthened during the war and as a consequence her manufacturing costs had risen much less than our own. The Government were however extremely reluctant to concede that our exports were not competitive and it took a great deal of pressure from the Americans and a huge run on sterling to persuade Sir Stafford Cripps to agree to devaluation. The Government then, as now, were motivated in part by fears of the effect on the cost of living. The fear was more real then than it is now since a very high proportion of our imports then consisted of food and basic materials, but in the event the effect of devaluation on domestic prices was considerably less than the experts had predicted. This was in part because so many other countries followed our example by devaluing to a greater or lesser extent and in part because, as always, the opponents of devaluation had placed on the fear of rising prices by exaggerating the possible adverse effects. The bankers, as reported in *The Economist* at the time, were strongly opposed to devaluation.

What the 1949 devaluation could not do was settle the right relationship between sterling and other currencies. The war had turned the rest of the world upside down and it would have been pure chance if the sterling rate and the associated cross rates had proved viable in the longer term. We were nevertheless chained to the 1949 parity by successive governments for a period of 18 years, long after it was apparent to anyone who cared to look at the facts that our goods were becoming steadily less competitive at home and abroad. Our share of world trade in manufactures fell from 25.5 per cent in 1950 to 16.5 per cent in 1960 while that of the Germans, for example, increased from 7.3 per cent to 19.3 per cent. Japan and Italy were likewise eating into our established markets. Imports of semi and finished manufactures increased over that period by 204 per cent and 380 per cent respectively. Our exports of manufactures increased by only 16 per cent.

We were undoubtedly unlucky in that we suffered more than any other country from the increase in raw material prices which followed the outbreak of the Korean War as well as from the shortage of steel and machine tools during the years of rearmament which followed. This coincided with a more than average increase in food prices when our long term contracts with Commonwealth countries on favourable terms expired. On the other hand we allowed ourselves to be lulled into a false sense of security as a result of the trade advantages we enjoyed in the Sterling Area and as a result of our own and other countries restrictions on imports from the Dollar Area and Japan. We should also have realised that our comparatively strong showing in the US market was evidence of the weakness of the dollar rather than the competitiveness of sterling. The fall in food and raw material prices in the late 1950s and early 1960s also helped to conceal the growing weakness of our position.

the recent past

The devaluation of 1967 came only after we had inflicted enormous damage on ourselves and the remedy was as usual too little and too late. Our prices had risen faster than those of our competitors in almost every year from 1950 onwards, but, as the index of competitiveness shows, the devaluation of 14.3 per cent in November 1967 only restored our competitive position to what it had been in 1962. What was needed to recover even half the ground lost to Germany since the early 1950s was a devaluation of the order of 30 per cent. We had, it is true, a balance of payments surplus on a current account in the years 1969-1972, but only as a result of massive deflation which no Government at that time would have regarded as permanently acceptable. The strength of the hard money men was however such that in 1971-2 the Bank of England took advantage of the inflow in foreign currency to *raise* the price of sterling by as much as 11 per cent against the dollar, thus wiping out nearly two thirds of such advantage as we had gained from the 1967 devaluation. This was done, moreover, at a time when our unit labour costs were rising considerably faster than those of our competitors. The effect was as disastrous as it was predictable. There was a massive increase in imports of manufactured goods in 1972 and 1973 and our share of world trade in manufactures fell to a new low of 8.8 per cent in 1974 compared to 21.7 per cent for Germany and 17.2 per cent, 14.5 per cent and 9.3 per cent for the USA, Japan and France respectively.

The Government's decision in 1974 to rely on the inflow of Arab and other money to finance the increase in our deficit as a result of the increase in the price of oil was consistent with what had been internationally agreed as the right way to deal with the problem which this had created for all countries. It was in any case not unreasonable because, quite apart from the fact that we would eventually be self-sufficient in oil, there was a reasonable prospect that we would be able to cover the greater part of our deficit on oil by increased exports of manufactures to the oil exporting countries. The oil deficit has in fact been wiped out and even without North Sea oil would not be much greater in real terms than it was in 1970. What was incredible, though, was the failure to use the exchange rate to halt the flood of manufactured imports from the Six. Indeed, on two occasions—the first quarter of 1974 and the second quarter of 1975—the Bank actually raised the rate against the dollar despite our much greater rate of inflation. This partly explains why our balance of trade in manufactures with the EEC Six has turned from a surplus of £96 million in 1970, excluding diamonds, to a deficit of £1,091 million in 1975, £1,347 million in 1976 and (at an annual rate) £1,457 million in the first six months of 1977. This is not, however, the only consideration. We are already having to pay well over £1,000 million a year to other EEC countries on account of higher food prices and our high contribution to the EEC budget.

The Government's long and damaging struggle in 1976 to resist a depreciation made inevitable by our inflation rate, its policy in the first half of 1977 of keeping sterling stable despite our growing uncompetitiveness, and, the decision reached in July, in the same week as record unemployment figures were announced, to allow the pound to float upwards on the strength of North Sea oil, can thus be seen as the continuation of a strategy with a long if not distinguished history. It is incredible as well as tragic that we are still intent on repeating our past mistakes and that each grim repetition is greeted with acclaim by those who have not yet perceived that a "strong" pound which makes our goods uncompetitive must impoverish the country.

3. common sense and economic nonsense

Many explanations have been advanced since the Second World War to account for our poor economic performance, but none have proved satisfactory because they have lacked historical perspective and so confused cause and effect. In the fifties the less sophisticated complained that our industries were at a disadvantage because our factories had not been destroyed during the war. The more sophisticated emphasised the problem of lower labour productivity and teams were sent to the United States to learn how we could lower our costs by more intelligent use of our existing manpower and machinery resources. In the sixties we tried to break out of the descending spiral by a " dash for growth " and when this failed we were told that the right policy was through mergers to create huge firms able and willing through concentration, rationalisation and re-equipment to make use of new technology on the scale required to enable us to compete with other countries. Throughout this period, we were also told that our problems would be solved by joining the EEC, even though this would mean opening up our home market to German, French and Italian competition, paying a good deal more for our food, and giving up important trade advantages in the Commonwealth, EFTA and the Irish Republic. Other explanations have become fashionable in the cold reality of the seventies. We have identified in turn overconsumption and underinvestment, misdirected investment, low profitability, trade union power, de-industrialisation, the shift from manufacturing to public employment, and now —most popular with the Establishment —control over the money supply.

market forces

The explanation which has been consistently overlooked or deliberately ignored is also the most obvious; that our difficulties are no greater than could have been expected as a result of the operation of market forces if, as we have argued is inescapably clear, the price of sterling in terms of competing currencies throughout the post war period, and indeed long before that, has been too high, effectively giving a subsidy to imports and imposing a tax on exports of never less than 10 per cent and at times as much as 20 per cent. This huge overvaluation of our currency has depressed the earnings of both capital and labour in industries which have thus been needlessly exposed to severe competition from foreign firms at home and abroad, and not surprisingly capital and labour have wherever possible moved out of these industries into areas offering a better or more secure return, either at home or abroad.

The effect has been cumulative; more and more employees at every level have left the industries in which pay and prospects are deteriorating and less and less money has been spent on new equipment, new product development and sales promotion. More and more employees have emigrated and more and more production has been transferred from this country to subsidiaries or associated firms overseas. Unit costs have risen faster than those of our competitors, in part because of the loss of talent at every level, but more particularly because production has fallen in absolute or in relative terms. This process has been accelerated rather than retarded by the efforts of successive governments to solve the balance of payments problem by squeezing domestic demand to compel firms to export at little or no profit, a policy which can only be made to work by repeated and ever stiffer doses of the same medicine. The car industry is a particularly good example of the process at work. Toyota, for example, has been able to invest twelve times more per worker than British Leyland and their labour productivity is, not surprisingly, five times as great.

What has been so notably missing from the discussion of economic policy is any suggestion that the exchange rate could be used as a positive instrument of policy, rather than as something which is simply to be defended. Virtually no attempt has been made to decide an exchange rate policy which would achieve, or make it possible to achieve, sustainable rates of growth, investment, employment, or trading performance. The experience of the past 18 months is particularly instructive as to the way in which we habitually approach such matters. We strenuously resisted, to the point of bankruptcy, the downward movement in the pound which our loss of competitiveness had made inevitable, and when our resistance proved futile, we proclaimed, in the face of all the facts, that the fall had made our exports unprecedently profitable and competitive. When export led growth nevertheless failed to materialise because no effective devaluation had taken place we are told that this simply demonstrates that devaluation does not work!

an instrument of policy

We shall be considering the arguments against devaluation in more detail later, but we need to be clear at the outset as to what we mean when we speak of devaluation as an instrument of policy. Those who are opposed to devaluation sometimes seek to obscure the whole issue by failing to distinguish between a nominal and an effective devaluation, that is between one which enables domestic producers simply to keep pace with the prices being charged by their foreign competitors despite a higher rate of domestic inflation, and one which enables domestic producers to charge less in terms of foreign currency and forces their foreign competitors to charge more in terms of the local currency.

What we are advocating is an *effective* devaluation which would do no more than restore our balance of trade in *manufactures* to what it was in 1970—a year in which we were in overall balance—but in conditions of *sustainable* growth.

The experience of our own and other countries shows that a devaluation which increases the competitiveness of exports and reduces the competitiveness of imports in terms of price is effective in steering resources into investment and exports in conditions of sustainable growth. In the case of the UK the beneficial effects have been relatively short lived, in part because devaluation has been only a partial response to an earlier loss of competitiveness and in part because of subsequent intervention by the Bank of England to minimise or reverse the impact of the devaluation. What would distinguish the strategy now being suggested from previous devaluations is that it would be a deliberate attempt to *regain* competitiveness and do so on a permanent basis by continuing to adjust the rate to hold the ground regained. The stimulus to growth and exporting which has in the past been a real though short lived consequence of devaluation, as shown by J Artus in his study of the 1967 devaluation in the IMF *State Papers* of November 1975, would become a permanent factor in the dynamic development of the economy.

Our view that price is an important if not the key factor in international trade is in fact amply borne out by the studies which have been made of price elasticities. Many of these have been summarised in a recent publication by the Trade Policy Research Centre, used by the Cambridge Economic Policy Group (CEPG) in their study of cost competitiveness and export shares. The "best estimate" for the price elasticity of demand for UK exports was there given as −2.00, greater over the period 1960-76 than the corresponding figure for our five principal competitors.

The Treasury have also said that they would expect a 10 per cent devaluation to result in an increase in the *volume* of manufactured exports of no less than 15 per cent and a reduction in the *volume* of manufactured imports of 5 per cent —10 per cent.

On this basis the devaluation required to increase the export surplus on manufactures to what it was in 1970 in real terms would be of the order of 6 per cent, but this comparison with 1970 depends on the change in unit values and these may not be reliable. We must then take into account the increase in imports of basic materials and foodstuffs which would occur in conditions of sustained growth;

the increase in costs attributable to membership of the Common Market; and the effect of all these changes on import and export costs when they had worked their way through the economy. This means that we must think in terms of one or more devaluations amounting to about 20 per cent, and possibly more if, as we strongly suspect, the current (August 1977) rate of exchange is much less favourable to British industry than the rate which determined the level of trade in the first half of the year, on which subject opinions will vary according to estimates of the time lags involved. We do not however share the CEPG view that a fall in UK relative costs of the order of 30 per cent will be required to maintain our share of world trade in 1980 and beyond. This is because a process of continuous expansion would begin to operate as soon as we began to make real headway in export markets.

the government's new industrial strategy

When the Chancellor argued in 1970 that our exports were more profitable and more competitive than they had been for many years it seems that he (or rather his advisors) had at last recognised the vital role of the exchange rate in achieving the Government's policy of industrial regeneration through export led growth, even if he had been wrongly advised on the facts. However, now that he has all but admitted that we are not competitive, it can be seen that nothing has changed. This was made only too clear in the 1977 Budget Speech, in which he accepted the crucial importance of price competitiveness, but said that this must be achieved through higher productivity and *not* through a lower exchange rate. The Chancellor also argued like so many of his predecessors that we must in addition improve our non price competitiveness by better product design, higher quality, and greater reliability allied to better salesmanship, delivery dates and servicing arrangements.

What Mr Healey did not explain was how these eminently desirable objectives, which have been inscribed on politicians' banners for many decades, are to be achieved. What is clearly required is more money for investment in new buildings, for better layouts in old buildings and for new and more productive machinery, but how is the money to be found when profits in real terms are only one third of what they were in the early sixties and even then were insufficient to enable us to keep abreast of our main rivals? Our problem is that we have to run very much faster simply to stop falling further behind in the productivity race. The idea that we can arrest our decline and actually gain on our competitors without injecting new resources into industry through greater profitability is simply wishful thinking.

It is completely unrealistic to assume that design, quality and delivery dates are not an aspect of price, and vice versa. All these desirable characteristics cost money and therefore affect price. Quality controllers cost money; more reliable components mean more research, improved production methods or better testing facilities, which all cost money; better and more numerous salesmen, especially abroad, cost money; better delivery dates usually cost very much more money because of the high cost of holding stocks, interrupting production schedules or just building extra capacity; and better servicing arrangements in export markets are particularly expensive to set up and maintain. It is time that the Chancellor and his advisers realised that in a competitive market price is the key variable in the mind of both buyer and seller. The buyer has to decide whether product A is worth more than product B even if the price is higher: and the seller of product A has to decide whether he can cut his price to match that of product B or offer the buyer other advantages to dissuade him from buying it. Businessmen who say that price is not of crucial importance in export markets cannot therefore be pursuing an optimum pricing policy: the prices they are charging must be too low if an increase in the value of sterling would not have a detrimental effect on sales and/or profitability. The scope for improvements in non price competitiveness can as we have seen only be obtained through an expanding and profitable export market for our industry and this in turn depends crucially on the stimulus to be gained through a reduction in the exchange rate. All the talk about an industrial strategy, which has no better chance of working than any of its innumerable predecessors, simply serves to obscure the basic issue.

the chancellor's misconception

What the Chancellor said in his 1977 Budget Speech is in any case based on a fundamental misapprehension. International trade is not about productivity and the like. It is about specialisation. The role of the exchange rate is to ensure that each country is able to balance its overseas accounts by concentrating on the goods and services which it is relatively good at producing, even in the case where everything produced in one country is produced less efficiently than in any other. The scope for international trade is created not by the difference in overall costs of production in different countries, but by the *variance* of production costs of particular products around the overall national average. This means that in conditions of exchange equilibrium production cannot and will not be concentrated in the world's most efficient enterprises if this would involve a *general* shift of activity from one country to another. This is why we import some manufactures from India and sell other products to the United States, but it is precisely because our rate of exchange has not been in equilibrium that there has in fact been a huge shift of production from this country to Germany, France, Italy and Japan.

The absence of exchange rate equilibrium is also at the root of the further misapprehension on which we have touched already: that it is necessary to restrain home consumption to make room for exports. Manufacturers would have no incentive to give priority to the home market if the export market were equally or more profitable, particularly where, as in so many cases, the scope for growth in the home market is limited. Manufacturers are likely to be inhibited from showing interest in export markets at the present time by uncertainty concerning the Government's intentions about the exchange rate, at a time of rapidly rising costs, but this is in fact just as much a problem in the case of the home market now that our tariffs on imports from the EEC Six have been eliminated. What we should therefore be seeking is an exchange rate strategy which will make exports and imports substitution profitable enough to warrant investment in new capacity. British industry has for too long been forced by an unrealistically high exchange rate to look upon exporting as a marginal activity and to be satisfied with levels of profitability based on the marginal cost of producing goods for export. The test should be whether exporters are prepared to borrow overseas to build new capacity wholly or mainly for export in the confident expectation that they will be able to repay the loan out of the profits earned on the new plant.

the past repeated

What the Government like to describe as their new industrial strategy is in fact no more than a refurbishing of the line that successive governments have been taking for at least 50 years. We do not deny that what is required to raise the standard of living is a reduction in unit costs through increased productivity, but this is no more likely to be achieved by ministerial exhortation in the future than it has in the past. The regeneration of British industry cannot be achieved without making exports more competitive and imports less so. The advantage of devaluation is that it can do precisely this. Unfortunately for the greater part of the past century of remorseless industrial and trading decline successive governments have resolutely eschewed any strategy based on a competitive exchange rate. The whole thrust of policy on exchange rate management has been in the opposite direction. The rate has been consistently fixed at an unrealistically high level, devaluation has been resisted until the very last minute, and when the pressure for devaluation could no longer be resisted the downward movement has always been of the bare minimum required to meet the needs of the immediate situation. The exchange rate for sterling has been viewed as a symbol to be defended at almost any cost. Each bitterly resisted retreat, yielding too little and too late, has carried with it the seeds of the long, damaging and fruitless battle to defend the next indefensible position.

the German example

Opponents of a competitive exchange rate strategy often point to the German experience to show that economic growth depends on increased productivity, rather than manipulating the exchange rate. The truth is that the Americans and ourselves forced an undervalued currency on the Germans in June 1948, when the old currency was taken out of circulation. At that time we were having to support Germany financially and were only too pleased that she should pay her own way as quickly as possible. Equally important however, was the advantage the Germans gained when their productivity recovered from the very low post war level, as it was bound to do. In 1948 German output per head was only 54 per cent of the pre war figure compared to 108 per cent in the UK and because of this it was very much easier for them to reduce their unit costs after devaluation than it was for us. The persistent critics within our gates have also forgotten, if they ever paused to consider the point, that Germany effectively devalued her currency as a consequence of joining the Common Market because she was able as a result of membership to raise her tariffs against the outside world as well as securing a substantial preference in the markets of the other five countries against her principal competitors.

The current situation in Germany is in any case very different from our own. It is certainly true that once an economy has launched itself on the path of increasing productivity and competitiveness it can take a small revaluation in its stride, especially if the revaluation is nicely judged to do just that. Once the investment has been made, the plant and machinery are in place, the skilled workforce built up, export markets developed and the reserves built up through massive trade surpluses a marginal revaluation of the kind in which the Germans specialise will do little or nothing to reduce competitiveness and may indeed reinforce the strength of the economy through reducing inflationary pressures. To argue, however, that we could launch ourselves on the same virtuous circle from our present starting point is to defy logic. An appreciating currency may well be beneficial to an economy which is growing in both size and competitiveness, but it would be a fatal prescription for an economy whose competitiveness was declining. This indeed was the error we made in the twenties and again in 1971-72. When our industrial decline has been arrested and reversed, which in turn depends on the establishment of a competitive exchange rate, we can look to the Germans as our model.

In any case, we should do well to study the policy which the Germans actually follow in regard to the exchange rate. Whereas our Government, urged on by the City and financial journalists, is busily holding our rate up and allowing it to rise, apparently oblivious to our minimal growth rate, declining competitiveness and rising unemployment, the Germans with their huge reserves, massive trade surplus, relatively high growth rate and growing share of world trade are so concerned at a slight rise in their comparatively low unemployment figure that they are concentrating on finding new means of preventing the mark from appreciating.

the cost of living objection

This was almost certainly the main reason for the Cabinet's decision that a further drop in the rate of exchange had to be avoided at all costs. We do not of course pretend that devaluation does not lead to an increase in import prices—that indeed is the intention in the case of competing imports—but we do believe that the inflationary impact has been greatly exaggerated and that the expansion of output which would result if sterling were to be *effectively* devalued would raise incomes more than prices, even in the short run. One of our ingrained beliefs is that our imports consist of foods, fuel and essential raw materials. The public is never told that nearly 60 per cent of our imports now consist of manufactured goods and that cheaper imports mean fewer jobs and a lower standard of living for our people. In 1955 finished manufactures accounted for only 5 per cent of our imports; in 1967, only ten years ago, they accounted for 19 per cent; now they account for 30 per cent. The proportion of semi manufactures has likewise increased from 18 per cent in 1955 to 25 per cent in 1967 and 27 per cent today. The share in each case would in fact be higher still if the increase in the price of oil imports of which are being rapidly replaced by North Sea production, had not inflated the import figures.

This brings us to another point. Most of any increase in the price of North Sea oil flows back to the taxpayer via the government "take" and it could be argued that because of the budgetary implications an increase in the price of crude oil as a result of devaluation could be largely ignored so far as the overall cost of living is concerned. So far as foodstuffs are concerned two thirds of our imports of foodstuffs are covered by the Green Pound and under the Common Agricultural Policy we are entitled to go on importing the foodstuffs concerned at prices which are determined by the higher Green rate of exchange until it suits us to reduce it. We are of course having to pay by virtue of EEC levies something like twice as much as the world price for most of the foodstuffs concerned, so there is every reason why the Government should continue to resist the pressures from many directions to raise the price of food imports by reducing the value of the Green Pound. This leaves basic materials as the only sensitive item, but these now account for only 11 per cent of our total imports and since this Government came to office the price has gone up much less than wholesale prices.

Moreover the prices of food, fuel and basic materials have risen less than wholesale prices, wage rates and earnings since the Government came to office in 1974 and it is therefore very misleading to blame the fall in the value of sterling for the continuing rise in prices. The fact is that in real terms we have been paying less for our imports than in 1974: the overall terms of trade improved from only 74.8 to 81.0 in 1975, 80.4 in 1976 and 80.5 in June 1977, a rise over the whole period of over 7 per cent.

The Chancellor argued in his 1977 Budget Speech that the increase of 10 per cent in the value of sterling since the previous October would mean a reduction of 3 per cent in the retail price index at the end of the year. What the Chancellor failed to appreciate however is that the reduction in the *standard* of living required to bring this about is almost certainly as great, if not considerably greater, than the hoped for reduction in the *cost* of living. Our standard of living has certainly fallen much further than was required to close the gap in the balance of payments and to provide the resources required for the (still awaited) regeneration of manufacturing industry. We could have achieved and could still achieve these objectives with a minimum adverse impact on our living standards by adopting a competitive exchange rate strategy. A devaluation of, say, 20 per cent would eventually raise prices by 5-6 per cent but it would also lead to import substitution and to a flood of export orders: firms would pay more in overtime and take on more workers, and the increase in manufacturing output would soon feed back to the service industries, including transport. A high proportion of our people would thus be earning enough, by the time the rise in import prices had worked through to the shops, to enable them to maintain and increase their standard of living.

And because the increase in economic activity would reduce the strain on the Exchequer the rest of the population could be helped by appropriate budgetary and other measures.

The examples of France and Italy in 1976 show how the exchange rate can be used to improve the balance of payments without reducing the standard of living. There is a very large margin of spare capacity in industry at the present time and even in this country it has been possible to reduce unit costs by up to 10 per cent on coming out of a recession. In practice, too, foreign suppliers would absorb part of the increased price of imports and cheaper home products would be substituted for imports which had increased in price. It is in any case an illusion to believe that the policies which the Government have been pursuing in the monetary field are not inflationary. Economic stagnation and declining living standards generate wage claims born of frustration at unending failure and broken promises. Rising unit labour costs and high interest rates to attract and hold foreign money can only increase inflationary pressures. The connection between lower import prices and pressure for higher wages is in any case tenuous and it would be stretching the bounds of credibility to suggest that those who combined to destroy the social contract will be persuaded to exercise restraint by the uncertain prospect that prices will rise by 2-3 per cent less as a result of the overvaluation of sterling. What would have carried much more weight was some evidence that the Government was master in its own house and was determined to reduce unemployment to tolerable proportions by making our goods fully competitive at home and abroad.

4. conventional wisdom

The only credible alternative to devaluation which has been put forward as a means of arresting the deindustrialisation of our country is some form of semi permanent import controls. There are however political and economic objections to such a course. The political objection is that it would create a great deal of ill will at home and abroad, leading inevitably to relaxations long before the measures had had time to take effect. The principal economic objections are that it would intensify existing and create new structural problems; and because it would operate on only one side of the trading account—and because of the difficulty in including invisibles—it would in present circumstances be much slower and much less effective than devaluation in raising output and employment. The only justification put forward by the Cambridge Economic Policy Group—whose economic model shows that devaluation would otherwise be the better alternative—is that the effect of quantitive restrictions on prices would be nil or negligible and that this would help reduce the rate of inflation.

This seems to us very largely wishful thinking. The shortages which would be created by a savage reduction in imports of the kind required would enable foreign suppliers to raise their prices, which would be only too easy if British prices were higher than foreign prices, as would generally be the case if sterling was overvalued. This is not something which could be prevented by price control, since foreign suppliers would be outside our jurisdiction and importers would be able to justify an increase in cash margins in view of their lower turnover. Moreover, as seen by the CEPG, import restrictions would actually result in an increase in imports of semi manufactures—presumably for use in making finished manufactures to replace goods previously imported—in which case the price of both semi and finished manufactures would rise. Experience after the war shows that prices rise when imports are restricted and at one stage, before it was made illegal, licences were changing hands for vast sums.

Another problem is that users would have very little incentive to switch their purchases to home produced goods. Importers and their customers, backed in many cases by their employees, would press for larger quotas on grounds of cost, performance, export requirements, lack of availability in the home market, the threat to jobs etcetera. Domestic suppliers would be equally reluctant to expand capacity in the expectation that their new customers would take the business abroad again as soon as opportunity offered; and because of the international implications the Government would not be able to offer them any assurances on this score. The shortfall in supplies would therefore be made up to a considerable extent by switching production from unprofitable exports to the more profitable home market, making our position from an employment and balance of payments point of view little better than before. There would be little incentive to adapt our economy to the ever changing pattern of world trade, making the problem of re-entry into a competitive trading system even more difficult.

This is not to say that import controls would not be a great improvement on the present position, which is the worst of all possible worlds, but they would at best be a stop gap to protect the reserves to allow time for consideration of other more effective measures. A great deal of nonsense is put out by Whitehall about the supposed evils of what they like to call a " siege economy ", but the real objection to import controls is that, like the Government's present policies, they cannot solve the problems created by a fundamental state of disequilibrium arising from an overvalued currency. It must also be borne in mind that no Government committed to membership of the EEC is going to impose quantitive restrictions on EEC imports.

international monetarism

This school of thought—of which the leading exponents in the country appear to be Messrs Ball, Burns and Laury of the London Business School—maintains that the rate of exchange ought to be allowed to rise in response to market forces and that any attempt to hold it down to make our exports more competitive is bound to fail because each country's price level is pegged to the world level and must move rapidly in line with it. The essence of their case, as set out in the March 1977 issue of the *Economic Journal*, is that in each country there is a minimum sustainable level of unemployment and that once unemployment falls below this figure wages will rise until domestic prices are again in line with world prices. The key to the problem of inflation as they see it is the level of real wages. They argue that any attempt by wage earners to increase the level of real wages above the "natural" or "maximum sustainable" rate must lead to an increase in unemployment if the money supply is kept under proper control, the only alternative in their view being *accelerating* inflation. They sought to demonstrate this in a series of elegant economic models, but were forced to admit that none explain why the UK economy has had a persistent tendency over a long period of years to run at a higher rate of inflation than that of, say, Germany and the USA. They have got round this difficulty, however, by assuming as a fact—without putting forward a single piece of evidence—that the devaluation of sterling in 1949 was excessive, that as a result sterling was undervalued for many years, and that because of this our competitive advantage at home and overseas was not eliminated by inflation until the mid sixties. They conclude that because of the undervaluation of sterling "the level of output was *higher*, unemployment was *lower*, and the balance of payments *better*, than it would otherwise have been".

inadequacies of monetarist theory

It goes without saying that prices tend to rise if money wages rise faster than real wages, but what the international monetarists fail to recognise is that what they describe as the sustainable rate of unemployment is in part a function of the exchange rate. We would argue that in this country unemployment has been much higher than it need have been over a period of many years because sterling has been persistently overvalued. In other words, real wages and therefore the minimum sustainable rate of *employment*, would have been much higher because in absence of the stop go policies of successive governments productivity would have been much higher. The constraint on output and employment since the Korean War has always been the balance of payments. Germany and Japan on the other hand, have been able to keep unemployment down to a very low level because their currencies have been persistently undervalued. In any case, what better justification could there be for the policy we are advocating than the prospect of another 15 years of higher output and lower unemployment? What can the international monetarists offer by way of prescription for our economic ills better than this?

If it were true that sterling was undervalued as a result of the 1949 devaluation the effect could not but have shown up in our trade with the rest of the world. The analysis in the supplement to the *Board of Trade Journal*, to which we referred in chapter 1, shows on the contrary that we were losing ground in every geographical and commodity market between 1955 and 1965. This is also very well documented in an article by Dr June Flanders in the August, 1963 issue of the *Bulletin* of the Oxford Institute of Statistics. Her conclusion was that but for the 1949 devaluation we would have been even less competitive.

The theories of the international monetarists do not in our view explain the emergence of persistent debtors and persistent creditors in international trade. Why if the Germans and Japanese were able to combine internal price stability with a huge and rising balance of payments surplus cannot we do the same? Moreover, even if the link between wages in one country and the price level in other countries is as immutable as the international monetarists insist, we would argue that they have completely misread the situation in the UK because they have failed to distinguish between nominal and effective devaluations and because they assume that sterling is undervalued. That this is so is evident from Professor Burns' article in *The Times* on 11 July 1977, which quotes with approval the Treasury statement of 9 April, 1976, that there was no economic justification for the pressure on sterling and which also describes the opposition to an appreciation in the price of sterling as the single minded pursuit of a price advantage regardless of the inflationary consequences. What we are concerned with, however, is a price disadvantage and the associated deflationary consequences. Our objective is no more than a competitive exchange rate.

The international monetarists would presumably accept that the exchange rate and its effect on export prices is of some consequence and that at any given time it might not be fixed at the optimum level. What they do not explain is what should be done in the case of a country which finds that it has an overvalued exchange rate. The assumption appears to be that this would be corrected by inflation in other countries, whose currencies would then be relatively undervalued, but it is not clear what happens if those other countries take steps to maintain their undue competitiveness. The evidence of what happened under the Gold Standard and the Gold Exchange Standard as we have seen is not encouraging in this respect. Output and employment languished from 1920 until we devalued in 1931 despite falling wages and prices because, as all now agree, sterling was overvalued. The problem is that correcting mechanisms depend on the whole hearted cooperation of all concerned and the example of Germany and Japan today shows that those who can gain by not playing the game will do so.

It is of course true that wages tend to rise faster after a devaluation, but we believe that in attributing this to devaluation the international monetarists confuse cause and effect. Wage restraint has only been introduced when there has been a balance of payments crisis; the restraint is inevitably arbitrary in its effect on individuals; and when after a year or so the internal and external pressures force the Government to devalue and relax the policy the effect is to release a flood of claims which, because of the devaluation, many employers are in a better position to meet. The need is to ensure that this is provided for in the margin of devaluation, but as we have seen this was not done in 1967.

successful devaluation

The fact is that other countries have managed to devalue successfully and have made devaluation stick for at least as long as has made the whole operation well worthwhile. The United States' share of world trade in manufactures fell steadily after the realignment of currencies in 1949, but the decline was arrested after the recession of 1958 and the appreciation of the Mark in 1961, whereas our share continued to decline. The devaluation of Sterling in 1967 and of the Franc in 1968 put renewed pressure on the Dollar despite a further small appreciation of the Mark with the result that the United States share of world trade declined until the Dollar was devalued in December 1971. This had the desired effect. The United States share of world trade increased from a low of 16.1 per cent in 1972 to 18.7 per cent in the third quarter of 1975 and although the position has deteriorated since the third quarter of 1976 the loss of competitiveness is due more to the exchange rate policies being pursued by other countries than to any shortcomings on the part of the United States. The Dollar's importance means that it has less room for manoeuvre than other currencies, but it is now falling against the Mark and other hard currencies in an endeavour to reduce a trade deficit of $25 billion and a payments deficit which could be as much as $10 billion in 1977.

The French have always had room for manoeuvre and have used it with great success since the end of the first world war. Their share of world trade in manufactures fell from a peak of 9.3 per cent in 1955, but the ground lost was more than recovered after the devaluations of 1957-58 to reach a new peak of 9.7 per cent in 1960. Their share fell again in the sixties to a low of 8.2 per cent, but after the 1968 devaluation it grew faster than that of any other country to reach a new peak of 10.2 per cent in 1975. They then ran into difficulties because they had made the mistake of tying themselves to the Mark in the currency "snake", but rather than follow our deflationary example by trying to maintain the rate they cut loose from the snake and let the Franc fall by 17 per cent from the high point reached in the second quarter of 1975. This enabled consumption and the rate of growth to increase by 4 per cent and 5 per cent respectively in 1976 without prejudice to the balance of payments, which showed a remarkable recovery in the early months of 1977.

The Italians have also prospered by not letting the exchange rate stand in the way of their exports. Their share of world trade in manufactures increased from 4.4 per cent in 1959 to 7.6 per cent in 1972, but although they too made the mistake of tying themselves to the Mark, they left the snake earlier than the French and let the Lira fall to a competitive level. This raised their share of world trade from a low of 6.4 per cent in the first quarter of 1976 to a near all time high of 7.7 per cent in the fourth quarter, and although they are still heavily in the red their visible exports have increased twice as fast as imports since 1974. Contrary to all expectation industrial production rose by an astonishing 18 per cent in November-December 1976 compared to a year earlier. Consumption and growth also rose by, respectively, 3 per cent and 4 per cent. Only the restrictive terms of the recent IMF loan seem likely to prevent a further significant advance in 1977 and 1978.

A variation of the international monetarist approach is represented by Samuel Brittan of the *Financial Times*, a much respected financial journalist whose views carry great weight in Whitehall. He argues that market forces should be allowed to prevail in the foreign exchange market by letting sterling float "cleanly".

clean floating

There can be no one who would deny that if it were not for North Sea oil and gas we would by now have a much lower exchange rate. In the first half of this year manufactured imports were 14 per cent higher than a year earlier compared to only 7½ per cent in the case of exports, and this at a time when the home market was more depressed than at any time since the thirties. Some of the imports were destined for the North Sea, but even if no account is taken of the saving on gas our non oil deficit is likely to be of the order of £2 billion this year and the same next. The figure would be £3-£4 billion in conditions of growth.

The question is therefore whether we should use the revenue from North Sea oil to bridge the actual and prospective deficit. Those who think we should ought to ask themselves whether they would be equally prepared to see the Government dispose of privately held overseas assets to finance current consumption. Our view is that oil is just as much a capital asset and should not be used to finance current consumption. One reason why our manufacturing industry fell behind that of other countries in the period up to 1914 was the increase in the production and export of coal; and when the demand for coal declined at home and abroad by two thirds we found that our economic and social structure was not adapted to the requirements of the modern world. Oil could have exactly the same effect on our economy. We could produce fewer goods for export and import more goods which we would otherwise have produced for ourselves. Indeed, this is precisely what will happen if sterling appreciates and whether or not the Government (who will get more of the revenue from oil which is not remitted abroad) spend the money or hand it back to the taxpayer to spend. The improvement in the oil balance would be offset by a deterioration in the non oil balance, the full effect of which would be felt in those parts of the country and among those sections of the population which depend for their livelihood on a prosperous manufacturing industry.

There would be no escape from this trap by investing the revenue from North Sea oil in industry. The monetary effect would be the same. What industry needs is a profitable market, but the higher the exchange rate the smaller the market and the lower the rate of profit. That is indeed what those who advocate a higher exchange rate want: lower prices. What we have got to do if we want to avoid the deindustrialisation of Britain is reduce the exchange rate to the level required to balance our current account net of oil and oil related transactions, using the revenue from oil to repay the IMF loan and the $17 billion of debt which falls due for repayment to foreign creditors in the next eight years; to strengthen the reserves; to recycle surplus cash in the same way as the OPEC countries; and if necessary to invest in productive assets overseas. This does not rule out the possibility of using part of the surplus this year and next to pay for increased imports in the event of the trade balance not responding quickly enough to a devaluation to make it possible for the Government to reflate the economy on the scale required to get unemployment down to an acceptable figure, but the aim must nevertheless be to get the rate down as quickly as possible to a competitive level.

purchasing power parities

Many people believe that in the long run differences in exchange rates must ultimately reflect differences in the price (and by implication the cost) of goods (and presumably services) in the average shopping basket in each country. What seems to have been overlooked by Whitehall and nearly everyone else is that exports are produced in each country by the most efficient firms in the most efficient industries and that the cost curves of most of these firms will almost certainly have described a different path over time than the average of industry generally, particularly where the firms in question have been able to expand to meet rising demand at home and, more especially, abroad. The converse is true of firms confronted with a decline in demand for their products. (This is the process which has been described as one of *continuous causation* and explains the "Kaldor paradox"—that the value of net exports appears *ex post* to respond perversely to effective changes in the exchange rate). The record of the car industry illustrates this point. In 1976 the UK industry produced 1.3 million cars and exported 0.6 million, both figures being virtually the same as in 1960. The Japanese car industry over the same period expanded its output from 165,000 to 5 million, of which 3 million were exported. Other examples which spring to mind are steel, motor cycles, television sets and shipbuilding, but although Japan is perhaps an extreme example it is clear that the same process has been at work in Germany, France and Italy, in one direction, and in the UK and the USA in the other. The Anglo-Saxons, by opting for a "strong" pound and a "strong" dollar actually condemned themselves to economic weakness and thereby surrendered the leadership of the free world. They crucified themselves upon the cross of gold.

It is sometimes argued—even in a recent second leader in the *Sunday Times*—that sterling must be undervalued because so many tourists come here to buy our goods. This is naive. One reason tourists like to shop in London is that it offers an unrivalled selection of shops great and small. Another is that wholesale and retail cash margins are much lower than on the continent, in part because the rate of VAT is much lower, but also on account of our low wages and efficient retailing. This makes it possible for tourists to buy for example Swedish and Italian suits in Marks and Spencers at a lower price than they can at home. Indeed, a high proportion of tourist purchases may have been imported in the first place. The tourists are mainly interested in buying clothing, but much of the clothing in our shops is either imported or made out of imported materials, principally from Hong Kong and other low cost countries. Clothing in fact is quite unrepresentative: the wholesale price between January 1976 and May 1977 had risen only 16 per cent compared to 25 per cent for wholesale prices generally and as much as 33 per cent for motor vehicles.

the Cambridge view

Writing in *The Times* on 18 July 1977, Mr Wynne Godley of the CEPG defended the case for import restrictions on the grounds that the large scale devaluation which would otherwise be required to promote export led growth could not be achieved because other countries would retaliate and because in the absence of an incomes policy the rise in money wages would very quickly wipe out virtually the whole of the advantage gained.

We were naturally pleased to learn that the CEPG calculations support our case for saying that sterling is overvalued. We do not believe, though, that there is a risk of retaliation, certainly not from within the EEC. We are enjoined under Article 107 of the Treaty of Rome to maintain a rate of exchange " to ensure equilibrium in our overall balance of payments whilst taking care to ensure a high level of employment and the stability of price levels ". This requirement is obviously capable of different interpretations, but in our view there is nothing in Article 107 which would justify retaliation from any other member state in the circumstances we have in mind, which is to reduce the price of sterling to whatever level is required to balance our payments on current account, but treating oil and oil related payments as part of the capital account. This does not mean that other EEC countries might not be justified in following us down in order to correct their own imbalance of trade, though because of the overvaluation of sterling each of the EEC Six has managed to export some of their unemployment to us and none more so than Germany, with whom our deficit on trade in manufactures is now running at something like £1,300 million a year compared to only £87 million in 1970. Indeed, as Mr John Pinder has shown in an article in the July 1977 issue of *International Affairs*, unemployment in Germany would rise by almost half if they played the game according to the rules. We can say of both Germany and Japan, as Keynes said in 1931 of the USA and France, that what is now required is " to set in motion the forces which will undermine and destroy their creditor position: the puzzle they have set the world admits logically of only one solution: that some way must be found of doing without their exports ". One way to do this in the case of Germany would be to invoke Article 107.

We are almost as sceptical of the reasoning behind Mr Godley's argument on wages. His view is that a large scale devaluation would result in a severe squeeze of real wages which would last about four years because the change in relative prices would make very little difference to output and employment in the short run, although it would eventually lead to real wages being higher than they would otherwise be. If he were right in this it is hard to see why other countries should retaliate, but we believe that a drop in the *effective* exchange rate of 15-20 per cent would have a dramatic and almost immediate effect on trade in, for example, motor cars and steel. In 1970 we had a favourable balance of trade in motor vehicles and components of £1,850 million, at current prices, but by the first half of 1977 this had fallen to only £662 million, at an annual rate. In the case of steel a surplus of £350 million in 1970 had turned into a deficit of £165 million in 1976. There was a small surplus in the case of steel in the first half of 1977, but, at £25 million at an annual rate, this was far smaller than in 1970. The deterioration is mainly due to membership of the Common Market. Our deficit with the EEC Six on motor cars alone is running at £766 million compared to £60 million in 1970 at current prices. In terms of numbers the figure is now close on 400,000 compared to a *surplus* of 9,000 in 1970. Our deficit with the Six on steel has likewise increased to £312 million, on textiles £78 million, and on footwear £90 million. The loss of our substantial tariff protection can only be compensated for by a reduction in price and in the real world this can only be achieved via the exchange rate. The industries concerned have ample spare capacity and all should be capable of making a very rapid recovery, provided, in the case of steel, that the EEC Commission do not introduce restrictions on trade, which they have threatened.

We also believe that the recession in other countries should make it possible to expand UK output much more quickly than in the past because if bottlenecks arise in meeting export orders it should be possible to supplement home production with imports of materials and components in short supply. We do not consider that the experience of other countries shows that an effective devaluation is slow to make itself felt in terms of production and trade, and because real wages have already fallen much more than was required to close the trade gap and finance export led growth we believe that a balance could be struck which would steer a middle course between import led stagnation on the one hand and successive large scale devaluations on the other. Mr Godley, like Mr Burns, fails to distinguish between a nominal and an effective devaluation. Had he done so he would have appreciated that the fall in living standards since 1974 cannot be attributed to an increase since then in the real price of imports and to that extent the trade unions have no ground for complaint if the exchange rate is now allowed to fall in line with the rise in domestic prices. The evidence suggests that the pressure for very substantial wage increases is not based on any very clear understanding of the link between imports and prices and the relatively small increase in the cost of living which would result from an effective devaluation of 15-20 per cent would not therefore weigh very heavily in the balance.

We do not believe that the trade unions or their members are in fact so short sighted that they would deliberately neutralise the effectiveness of devaluation as a means of increasing output and employment. What has been lacking is a genuine policy of export led growth in which management and labour could repose any confidence. What the trade unions have actually been faced with is what now looks as if it was indeed a false prospectus in which the workers were promised the shadow of export led growth for the substance of an unnecessary cut in real wages.

5. a programme for recovery

The system of international payments established in accordance with the agreement reached at Bretton Woods in 1944 worked only because the Americans accepted the responsibilities of a creditor country, by pressing the debtor countries to allow their currencies to depreciate against the dollar; encouraging their exports to the United States; agreeing to large scale tariff reductions from which other countries generally derived the greater gain; and by assenting to highly discriminatory trading arrangements by trading blocs, particularly in the agricultural field, which could only be damaging to US exports. The prosperity of Western Europe and Japan in the quarter century from 1949 to 1974 is almost entirely due to this benevolence, and to the American willingness to go on financing a huge trading and balance of payments deficit despite the inroads which Germany and Japan were making into her markets at home and overseas.

The system has now broken down because Germany and Japan gained the surplus the Americans had lost and then refused to play the game according to the unwritten as opposed to the written rules. The German reserves rose from $2.27 billion in 1955 to $12.69 billion in 1970 as the US reserves fell from $21.79 billion to $12.56 billion. The UK reserves over the same period grew from $2.12 billion to only $2.83 billion and the Japanese from $0.77 billion to $3.87 billion. This however was only the beginning. In December 1976 the German reserves had increased to an enormous $32.32 billion and the Japanese to $15.28 billion. The American total had increased a little to $13.88 billion and our reserves had increased proportionately more to $4.23 billion. The French had meanwhile emerged as a new creditor, their reserves having increased from $1.91 billion in 1955 to $4.96 billion in 1970 and $8.75 billion in December 1976, though this last figure represents a very sharp drop on the average of $11.86 billion in 1975. The Germans have nevertheless successfully resisted all the pressure which has been put on them to reflate their economy and both they and the Japanese have allowed their currencies to appreciate only when they have had to make some concession to international opinion and then only when they have been quite sure that the consequences for their exports would be nil or negligible.

The problem is that the international payments system is in fundamental disequilibrium. The counterpart of the huge surpluses which have been piled up by Germany and Japan is an industrial structure in which these countries have built up a huge export trade in items which are not readily saleable on their home parkets, especially in current market conditions. An effective appreciation of their currencies, that is one which would move them from substantial surplus to substantial deficit, would be bound to increase their level of unemployment substantially. Mr Pinder has estimated that in the case of Germany unemployment would rise by two percentage points, that is by nearly half the present figure. In other words, the Germans have succeeded in exporting their unemployment to other industrial countries and none more so than the UK, which has substantially the highest rate of unemployment of any major industrial country outside the United States. We estimate that the increase in our bilateral deficit with Germany since 1970 has cost us at least 250,000 jobs and if account is taken of the inroads which the Germans have made on our markets overseas the total is well over twice as high.

Consideration of the German and Japanese cases leads to a conclusion which is very important in the context of the current debate in the financial press on the future of sterling. It is clear that a huge increase in the reserves can be accommodated *without* increasing the money supply to the extent that wages and prices rise to cancel out the advantage gained from an undervalued currency. This is very much a matter of technique, in which the expertise of the Treasury and the Bank evidently leaves very much to be desired, but there is clearly no reason why an increase in the reserves should necessarily be inflationary. At the present time there is in any case everything to be said for an increase in the money supply, though whether even this would be effective in raising output and employment is very questionable.

The fact is that wages and prices are not bound to rise in a country with an undervalued currency to an extent which would within a politically or even economically meaningful period of time eliminate the initial advantage gained from the undervaluation. Germany and Japan have on any meaningful interpretation both had an undervalued currency for a quarter of a century and show no signs of losing their competitive edge. The fact that Messrs Ball, Burns and Laury were able to prove the opposite by using their economic model of the UK case was only made possible by their assumption that sterling was undervalued from 1949 to the mid sixties, a propositon which we have seen cannot be made to fit any of the facts. Our view indeed is that divergence rather than convergence has exemplified the monetary system, though this could have been avoided in our own case if successive politicians acting on bad advice had not attempted to fit the economy into the procrustean bed of existing exchange rates by cutting off its means of advancement.

How bad that advice has repeatedly been since the second world war is evident from an article in the *London and Cambridge Economic Bulletin* commenting on the Budget of 1962 and published in *The Times Review of Industry* in June 1962. This was revealingly entitled " Waiting for Exports " and in it Messrs Tress and Fleming put in far more precise and elegant terms most of the arguments in this pamphlet against using deflation to remedy cost inflation either on its own or as a useful accompaniment to a specific incomes policy. They pointed out that long " stops " and short " starts " inhibit innovation and investment in more efficient methods of production upon which, in a rapidly changing world, the ability of a highly industrialised country to hold its export markets, let alone enlarge them, must depend: that if growth of output is to take place in a state of deflation, then the growth of demand will have to be interrupted from time to time to prevent unemployed resources being drawn back into use, thus reducing the average rate of growth over time: and that deflation is neither a necessary nor a sufficient condition for modifying the attitudes of both sides of industry to collective wage bargaining to enable British exporters to get their costs down to the level of their competitors. They argued that an incomes policy needs a high rate of growth in order to succeed; first, because the greater the rate of growth the less difficult it will be to persuade people to moderate their demands for higher money incomes, and secondly, because the higher the *average* rise in money incomes, the greater can be the dispersion around that average of increases for different groups of workers, to allow for the variety of demand-supply relationships in the labour market. They were thus driven to the conclusion, amply justified in the light of subsequent events, that a pay policy accompanied by deflation could only invite defeat.

current trends

It is a sad commentary on the effectiveness of parliamentary government that very little has changed since 1962. True to the century old policies of successive British Governments, the present Government is once again allowing the interests of the money economy to prevail over those of the real economy. Those who deal in money are no doubt very pleased with recent developments, but those who make things, and on whom the real prosperity of this country depends, must be less so. The latest indicators all show clearly, as was indeed predicted by the authors 18 months ago, that industrial production is actually falling back, that exports of manufactures are growing much less slowly than imports of manufactures, that industrial investment is stagnant, and that unemployment is rising inexorably. These statistical indicators are again reinforced by the CBI survey for July which shows that there is now less optimism as to exports, that export orders are being obtained only by cutting margins substantially, and that price competitiveness is increasingly an inhibiting factor in securing new orders. We have managed to place ourselves once again on the treadmill of declining competitiveness and profitability in export markets.

All this will come as a surprise only to those who have managed to suspend all common sense by arguing that raising our export prices by pushing up the exchange rate will have little effect on the foreign customers' willingness to buy or the British manufacturers' ability and incentive to sell. It is tempting to say that the writing on the wall can no longer be ignored, but those who frame our policy are so well practised in averting their gaze from reality, and the writing has been on the wall for so long, that one despairs that any further evidence will make any difference.

This pessimism is reinforced by the latest development in exchange rate policy. Urged on by the City and financial journalists, and to the general acclaim of the ill informed, the pound is allowed to rise in value, despite the fact that it would have to fall substantially even to maintain our inadequate competitiveness of a year ago. It is the return to the gold standard all over again, with the exchange rate once again being regarded as of value in itself and a symbol in which we should all take pride. We tell ourselves that a rising pound must be good for us, whatever the underlying condition of the real economy, thereby exhibiting in the management of our national economic affairs a lack of common sense which would be laughed to scorn by any housewife. There are even those who, with a magnificent confusion of cause and effect, argue that the secret of the German economic miracle is that they have revalued their currency, thereby making their goods more expensive and in consequence more readily saleable at the quality end of the market, and that all we need to do to achieve a similar economic success is to make our goods more expensive too. King Canute would have been proud of us.

We have never found it difficult to produce short term reasons for holding the exchange rate at the highest possible level. Today is no exception. We are now told that the pound must be pushed up as a means of fighting inflation. Even if the most extreme case for the influence of the exchange rate on the rate of inflation were accepted, it is hard to believe that trade union negotiators would be very much impressed by the sort of marginal reduction in the inflation rate which could be achieved by pushing up the value of sterling. Indeed, the 7 per cent improvement in the terms of trade since 1974 did not have very much effect on the negotiations for Phase Three of that Social Contract and it it most unlikely that even a substantial further improvement would have much effect on the current round of wage claims. A substantial fall in the external value of sterling might well have been much more salutory in this respect, if only as an instant reminder that excessive wage increases can only be self defeating. The tragedy is that such a damaging policy does not achieve the one thing which is claimed for it. It is in fact an extremely bad way of trying to combat inflation since by reducing our competitiveness and rate of growth, unit labour costs are inevitably forced up, and by reducing real living standards the pressures for increases in money wage are inevitably strengthened.

It is only the accident of North Sea oil which permits the Government (or should one say their advisers?) to foist such a policy on the long suffering British public. We ought to be using the finite resources of the North Sea to repay our huge debts, to build up our reserves and if necessary, but only when we had achieved the objectives of sustained export led growth, to invest overseas. This would give us much greater freedom of action than we have recently enjoyed, both to run a balance of payments deficit in the short term if an effective devaluation should produce a genuine "J curve", and to choose an exchange rate which suited the objective of export led growth without the fear that the downward movement would get out of hand as a result of speculation of the kind we experienced in 1976. Unfortunately it is only too clear that the Government have decided to rely on North Sea oil to bolster the exchange rate, finance the public sector deficit and correct the balance of payments without attempting to do anything to stop the rapid increase in imports of manufacturers. This is the rake's progress to ruin and a denial of everything the Prime Minister said at the Labour Party Conference in 1976. It means drawing on a capital asset to finance current consumption—a policy which would rightly be condemned root and branch by the City if it entailed the compulsory sale of privately owned overseas assets, but is apparently accepted with equanimity in the case of publicly owned oil and gas. The policy spells disaster for British industry, particularly manufacturing industry in the regions and more especially in the engineering Midlands as well as in Scotland and the North-East. It means accepting a loss of competitiveness internationally and a heavy adverse balance of visible trade, excluding oil, accompanied by a big increase in unemployment in the industries principally affected, including in particular the car industry and its suppliers. It also means accepting an acceleration in the process of deindustrialisation, increasing the tensions in our society as job opportunities for the unskilled disappear, and when the flow of oil and gas begins to decline, or if the price falls, depriving ourselves of the industrial base required to maintain our standard of living as well as to pay our way in the world.

The dangers should be obvious, but such is our capacity for taking the wrong decisions and sticking to them bravely that there is a real danger of their being ignored or discounted. There are indeed powerful vested interests to be overcome, including those who stand to gain as a result of recent speculation in the foreign market, those who have borrowed overseas to finance ill timed expansion, those in Whitehall responsible for prices and incomes who not unnaturally clutch at any straw in their efforts to secure an orderly return to free collective bargaining, those who are opposed to any move which would increase the disparity in agricultural prices within the EEC and further complicate the process of harmonisation within the Common Market, and those who are motivated by nothing more than their overriding desire to do nothing which might help this Government to win the next election.

Unemployment, contrary to what many in the City would have us believe, is not a problem which can be solved only by international action. It has arisen principally as a result of the beggar-my-neighbour policies pursued by Germany and Japan, and it can just as easily be solved—as Keynes put it in 1931—by setting in motion the forces which will undermine and destroy their creditor position. The terms of trade index for manufactures in July 1977, at 103, was almost as high as in 1966-67 and 1971-72, and there is little doubt but that it would have been higher than in both periods if it had been able to take into account the full effect of tariff changes as a result of joining the EEC. The same is likely to be true of the competitiveness index, for which up to date figures are not available. This leads to the conclusion that what is required is a measure of devaluation which would at least restore both indices to what they were in 1968-69 and the winter of 1973-74, though because of the loss of tariff protection in home and overseas markets and because the rate which prevailed earlier was never sufficient to sustain growth, we believe that the objective must be to get both indices down to 85-90. This implies a rate against the dollar of about $1.50 in terms of July 1977 prices, though to maintain our position it would have to fall in relation to the currencies of our principal competitors by roughly 1 per cent per month thereafter.

It may be asked how the rate of exchange can be reduced when all the pressures are in the other direction. The answer is that the Bank of England must be told to let the rate of interest fall—and if necessary push it down—until the objective is achieved. They must also be told not to intervene in the foreign exchange market to support sterling, as they did, for example, in May 1977 at a cost to the reserves of £600 million. Indeed, the inflow of hot money into London is entirely due to the policy of the Bank in putting a floor of $1.71 under sterling, which invited every speculator in the City to buy sterling, not only because the rate of interest was and still is higher in London, but also because there was the possibility that the inflow of funds in response to what was in effect a guarantee against exchange losses might push up the price of sterling and yield an exchange profit. The inflow did have the advantage that it forced the rate of interest below the level which the Bank was trying to dictate to the market to accomplish their deflationary purpose, but just as the situation had been created by the Bank, so it could have been put right by confident and competent handling of the money market. What is now required is an openly proclaimed withdrawal of the guarantee. This will stop the inflow of funds and exact a heavy penalty from those who withdraw funds already here. The Government should at the same time encourage the pound to fall by repaying the IMF loan, not because the restrictions on the money supply are biting—there is in fact ample room for expansion—but because it would show that the Government was master in its own house. The world would know that what the Prime Minister said a year ago about the need for industrial regeneration through export led growth was not just a smokescreen to conceal the introduction of policies whose effect would be the exact opposite.

This is not just a plea for economic expansion—for which a substantial increase in the money supply is an essential though not a sufficient condition—for even if the Government cannot be deflected from their politically and economically suicidal course of confrontation with the Unions through deflation it would make sense to push the pound down to a competitive level to encourage manpower and material resources to move into import competing and export industries. Free collective bargaining will produce the wrong answer if the pound is overvalued.

There is an inevitable price to be paid for our past mistakes and failures. It is vitally important that we should choose the least important of all the evils which confront us and that we should pay the price in a form which at least offers us the chance of breaking out of our downward spiral. We must adopt a strategy which provides some hope of growth and rising living standards, and that is only possible if we establish and maintain a competitive exchange rate.

appendix: tables

UK TRADE IN MANUFACTURES (1970=100)

year	share of world trade	terms of trade	competition index	change in relative volume	annual change of terms of trade	rate of change in relative volume
1950	247			271		
1951	213	80.7		218		−19.6
1952	209	84.1		203	+ 4.2	− 6.9
1953	207	85.5		218	+ 1.7	+ 7.4
1954	198	88.9		212	+ 4.0	− 2.8
1955	192	84.4	93.1	183	− 5.1	−13.7
1956	186	85.9	94.1	197	+ 1.8	+ 7.6
1957	176	94.5	94.2	193	+10.0	− 2.0
1958	175	100	96.7	181	+ 5.8	− 6.2
1959	170	98.6	97.6	167	− 1.4	− 7.7
1960	156	97.3	97.5	128	− 1.3	−23.4
1961	155	98.6	97.5	138	+ 1.3	+ 7.8
1962	146	101.4	99.5	135	+ 2.8	− 2.2
1963	144	102.7	99.8	133	+ 1.2	− 1.5
1964	134	101.3	100.1	114	− 1.4	−14.3
1965	130	102.6	102.2	119	+ 1.3	+ 4.4
1966	125	103.8	104.5	116	+ 1.2	− 2.5
1967	115	103.7	104.1	101	− 0.1	−12.9
1968	107	97.8	98.1	99	− 5.7	− 2.0
1969	106	97.9	98.0	105	+ 0.1	+ 6.0
1970	100	100	100	100	+ 2.1	− 4.8
1971	103	104.0	102.2	100	+ 4.0	0
1972	94	105.7	102.6	85	+ 1.6	−15.0
1973	89	97.6	94.1	81	− 8.7	− 4.7
1974	83	92.8	93.1	81	+ 4.9	0
1975	88	102.1	96.5	84	+10.0	+ 3.7
all 1976	82	100.8	95.2	83	− 1.3	− 1.2
first quarter 1976	87	103.9	99.3	86	− 1.8	+ 1.2
second quarter 1976	93	100.9	94.5	84	− 2.9	− 2.3
third quarter 1976	81	100.4	95.3	81	− 0.5	− 3.6
fourth quarter 1976	78	99.2	91.6	81	− 1.2	0
first quarter 1977		102.7	97.6*	79	+ 3.5	− 2.5
second quarter 1977		102.2	97.8*	81	− 0.5	+ 2.5

* estimated

Source: *Monthly Review of External Trade Statistics, Trade and Industry,* UN *Statistics* and *Annual Abstract* prior to 1954. Share of world trade prior to 1958 includes 0.6 percentage points to compensate for the exclusion of re-exports from that date. Relative volume equals export volume divided by import volume. The competition index is the ratio of UK manufactured prices to the weighted average of the other eleven main manufacturing countries expressed in dollars. (A rise in the ratio shows a worsening position.)

PRICES AND RELATIVE VOLUME (1970=100)

	chemicals		manufactures		engineering		other manufactures	
	price	volume	price	volume	price	volume	price	volume
1971	100	107	106	105	102	96	97	97
1972	100	100	106	97	105	73	94	98
1973	91	102	97	99	101	64	89	74
1974	82	112	94	89	104	66	82	81
1975	91	117	105	86	107	73	85	78
1976	89	113	96	91	106	67	83	86
first quarter 1977	90	104	103	95	110	61	83	81
second quarter 1977	92	111	101	99	110	59	83	91

Note: Both series are exports divided by imports. Higher numbers mean higher prices or volume for exports.

SHARES OF WORLD TRADE IN MANUFACTURED GOODS

	UK	Germany	USA	Japan	France	Italy
1899	32.5	22.4	11.2	1.5	15.8	3.7
1913	29.9	26.4	12.6	2.4	12.9	3.6
1938	22.1	22.7	20.0	6.6	6.5	2.9
1950	25.5	7.3	27.3	3.4	9.9	n.a.
1960	16.5	19.3	21.6	6.9	9.6	5.1
1970	10.6	19.9	18.6	11.7	8.8	7.2
1975	9.3	20.3	17.7	13.6	10.2	7.4
1976	8.8	20.6	17.3	14.7	9.8	7.1
1976 fourth quarter	8.2	21.1	16.3	15.0	9.8	7.4

MANUFACTURED EXPORT PRICES: INCREASE SINCE 1970 AS PERCENTAGE OF UK INCREASE

	1973	1974	1975	1976	1977
UK	100	100	100	100	100
USA	89	90	90	97	88
Germany	116	112	110	111	112
Japan	111	118	103	101	107
France	113	106	111	110	105
Italy	99	101	102	95	97

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a competitive pound

The authors believe that the most important single reason for the poor performance of the British economy in this century has been that the pound has been overvalued in terms of foreign currencies. As a result exports have been neither sufficiently profitable nor competitive causing Britain's share of world trade to steadily fall, and the growth of productivity and the level of investment to be less than those of her competitors.

The authors argue that the devaluations that have taken place since the war have not been sufficient, once internal inflation has been taken into account to keep the currency competitive and evidence is given that the pound is now less competitive than at almost any time in this century. It is argued that if North Seea oil reserves are used to hold up the exchange rate the consequences for industry, investment and employment will be ruinous.

The role of import controls in a strategy for recovery is examined and the authors argue that a competitive exchange rate strategy is preferable in almost every respect. In conclusion the authors state their belief that the government's current strategy has no more chance of success than any of its predecessors and that a 20 per cent devaluation is an essential pre-condition for economic recovery.

fabian society

The Fabian Society exists to further socialist education and research. It is affiliated to the Labour Party, both nationally and locally, and embraces all shades of socialist opinion within its ranks — left, right and centre. Since 1884 the Fabian Society has enrolled thoughtful socialists who are prepared to discuss the essential questions of democratic socialism and relate them to practical plans for building socialism in a changing world. Beyond this the Society has no collective policy. It puts forward no resolutions of a political character. The Society's members are active in their Labour parties, trade unions and co-operatives. They are representative of the labour movement, practical people concerned to study and discuss problems that matter.

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