

# *Britain's Economic Situation*

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## **Summary**

*The economic situation is appraised having regard to Britain's international trading position, the fundamental commitment to sustain sterling as an independent currency and the desirability of maintaining confidence in the management of public finances. The results of the analysis are used as a basis to judge the scope for government intervention. The possibility of increasing labour productivity by enhanced support for workplace learning is an option that might be considered. Official misunderstanding of the influence exerted by the exchange rate is shown to be unhelpful when considering government policy. Things look bad.*

## **Introduction**

This essay gives my assessment of the country's economic situation, made in the early part of this year. My basic premise is that sterling will remain a sovereign currency. It seems plain that the option of joining the Eurozone will not be offered in a referendum, whatever else may be. This means that for the foreseeable future it's important to understand the role of the exchange rate as it affects the British economy.

## **The Role of the Exchange Rate**

It makes sense to discuss the implications of this in terms of an analysis that distinguishes between two different sorts of economic activity. One sort generates 'tradables': goods or services that are also readily available from suppliers abroad (e.g. feed wheat, motor-cars, consultancy). The other sort generates 'non-tradables': things that are inherently confined to these shores (e.g. domestic care services, residential property, the infrastructure of the public realm).

This distinction matters because of the difference the exchange rate makes to prices when it alters. Prices of tradables are set in international markets, influenced by global effective demand and availability of supplies. These prices are not set in sterling terms. Even the price of Brent Crude, an international benchmark price based on British oil, is always quoted in terms of US\$. These international prices (of tradables) are translated into sterling by the exchange rate. When the exchange rate alters, so do the prices of tradables as expressed in sterling terms. Meanwhile, the prices of non-tradables are set in the local British market directly in sterling terms and not altered by the exchange rate.

This is an important observation. It illustrates the pivotal role of the exchange rate. When the exchange rate falls, the prices of tradables all rise whilst the prices of non-tradables are unaffected. When the exchange rate rises, the prices of tradables all fall whilst the prices of non-tradables are unaffected. So a change in the exchange rate alters the price relativity of tradables *vis-à-vis* non-tradables, a signal encouraging a change in the balance between the two sectors within the British economy.

## Analysing National Accounts

Because of its crucial significance, I think it's worth putting some dimensions on the tradables and non-tradables sectors in the context of the economy as a whole. Fortunately these different parts of the national economy can be readily identified from the accounts presented by the Office for National Statistics in the form of Supply & Use Tables.

**Table 1: Some 'tradables' and 'non-tradables' sectors identified from the 2010 Supply & Use Tables**  
(data from: SUTS 2010, ONS)

ECONOMIC SECTOR	£ million			Imports as % Supply	Exports as % Supply
	Supply	Imports	Exports		
<b>SELECTED TRADABLES:</b>					
Alcoholic beverages	40715	7270	5969	17.9	14.7
Coke and refined petroleum products	75126	18093	16754	24.1	22.3
Paints, varnishes and similar coatings, printing ink and mastics	6199	911	1256	14.7	20.3
Soap and detergents, cleaning and polishing preparations, perfumes and toilet preparations	21335	3964	3991	18.6	18.7
Industrial gases, inorganics and fertilizers (all inorganic chemicals)	12022	2687	3349	22.4	27.9
Petrochemicals	32838	13648	12354	41.6	37.6
Dyestuffs, agro-chemicals	3954	1115	1666	28.2	42.1
Rubber and plastic products	31586	9289	6221	29.4	19.7
Basic iron and steel	18326	5208	5107	28.4	27.9
Motor vehicles, trailers and semi-trailers	96656	35453	25750	36.7	26.6
Ships and boats	6311	2506	1734	39.7	27.5
<b>SELECTED NON-TRADABLES:</b>					
Sewerage services; sewage sludge	6443	0	0	0.0	0.0
Owner-Occupiers' Housing Services	101931	0	0	0.0	0.0
Veterinary services	3062	0	0	0.0	0.0
Residential care services	32109	0	0	0.0	0.0
Services furnished by membership organisations	11287	0	0	0.0	0.0

It's worth emphasising that when things are tradables they tend to be traded both ways: there are exports leaving the country and there are imports coming in at the same time. Take alcoholic beverages for example: of the £40715million total supply available in 2010, £7270million came from abroad (imports) and £5969million ended up overseas (exports). And although the UK is a 'net importer' of petrochemicals, it is still a substantial exporter (£12354million, 37.6% of supply). Whilst net trade in soap and detergents, cleaning and polishing preparations, perfumes and toilet preparations is negligible, there are substantial amounts both of imports (£3964million, 18.6% of supply) and of exports (£3991million, 18.7% of supply). Tradables aren't unambiguously either exports or imports; but they are definitely **not** non-tradables. Non-tradables can't be sold abroad and can't be bought from overseas; hence the zeroes in the table for imports and exports of residential care services, which is nevertheless a significant area of UK economic activity (total supply £32109million; similar in scale to petrochemicals £32838million; or rubber and plastic products £31586million).

A summary of national accounts considered on the basis of the distinction between the tradables and non-tradables sectors is given in Table 2.

**Table 2: Inter-sectoral flows in the national accounts 2010 (data in £million)**

(data from: SUTS 2010, ONS)

	<b>Tradables</b>	<b>Nontradables</b>	<b>All Intermediate</b>	<b>Final Demand</b>	<b>Total Supply</b>
<b>Tradables</b>	609877	357680	967557	1136446	2104003
<b>Nontradables</b>	129339	263331	392670	809509	1202179
<b>Total</b>	739216	621011	1360227	1945955	3306182

The UK's total gross output or supply in 2010 was £3306182million. Tradables accounted for 63.6% of this (£2104003million), non-tradables for 36.4% (£1202179million). Quite a lot of this overall economic activity involves sales within and between the productive sectors themselves. There is an interesting asymmetry about these inter-sectoral transactions. Transactions within the tradables sector itself (£609877million) represent 82.5% of the sector's total intermediate input purchases (£739216million) and 63.0% of its intermediate sales (£967557). The tradables sector purchases relatively little from the non-tradables sector (£129339, 17.5% of total intermediate input purchases by the tradables sector). By contrast the non-tradables sector has total intermediate input purchases of £621011million most of which (£357680million, 57.6%) comes from the tradables sector. This asymmetry of interdependence between the two sectors will be important when it comes to measurement of relative overall economic impact.

This 'intermediate' or 'business-to-business' (B2B) activity is important in itself of course, but, because it's recognised that the ultimate purpose of economic activity is to provide for people's consumption, it is 'final demand' (£1945955million; including purchases by or on behalf of households) that better represents the national standard of living. Tradables contribute the most to this (£1136446million, 58.4%), non-tradables deliver £809509million (41.6%).

### **Contributions to National Value Added**

Before considering final demand in more detail, Table 3 gives a description of the way profits and pay are distributed within the economy.

**Table 3: Pay and profit according to sector in 2010 (data in £million)**

(data from: SUTS 2010, ONS)

	<b>Tradables</b>	<b>Nontradables</b>	<b>Total</b>
<b>Compensation of Employees (Pay)</b>	391742	404679	796421
<b>Gross Operating Surplus and Mixed Income (Profit)</b>	248020	242797	490817
<b>Pay plus Profit</b>	639762	647476	1287238

Together, pay (compensation of employees) and profit (gross operating surplus and mixed income) contribute £1287238million to the total 'value added' of the UK economy. Pay (£796421million) accounts for 61.9% of this contribution and profit 38.1% (£490817million). It is very interesting to note that the tradables and the non-tradables sectors contribute equally ('half-and-half') both to total pay and to total profit within the UK economy. This suggests that the two sectors should be considered as of equal importance when assessing the country's economic situation.

## Final Demand

Tables 4, 5 and 6 offer an analysis of final demand for tradables and for non-tradables broken down to identify the contributions due to households, non-profit institutions serving households, central government, local government, gross fixed capital formation (investment) and exports.

**Table 4: The composition of final demand in 2010 (data in £million)**

(data from: SUTS 2010, ONS)

	Households	NPISH	Cen'gov	Loc'gov	GFCF	Exports	Total
<b>Tradables</b>	589941	1875	1498	8182	97477	437473	1136446
<b>Nontradables</b>	314018	35703	203640	121720	124016	10412	809509
<b>Total</b>	903959	37578	205138	129902	221493	447885	1945955

**Table 5: The composition of final demand in 2010 (% within sectors)**

(data from: SUTS 2010, ONS)

	Households	NPISH	Cen'gov	Loc'gov	GFCF	Exports	Total
<b>Tradables</b>	51.9	0.2	0.1	0.7	8.6	38.5	100.0
<b>Nontradables</b>	38.8	4.4	25.2	15.0	15.3	1.3	100.0
<b>Total</b>	46.5	1.9	10.5	6.7	11.4	23.0	100.0

**Table 6: The composition of final demand in 2010 (% between sectors)**

(data from: SUTS 2010, ONS)

	Households	NPISH	Cen'gov	Loc'gov	GFCF	Exports	Total
<b>Tradables</b>	65.3	5.0	0.7	6.3	44.0	97.7	58.4
<b>Nontradables</b>	34.7	95.0	99.3	93.7	56.0	2.3	41.6
<b>Total</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Final demand for tradables (£1136446) is dominated by sales to households (51.9%) and sales abroad (38.5%). Whereas final demand for non-tradables is balanced between households' purchases (38.8%) and purchases by central and local government (40.2%); education, health and social care are responsible for most of this government expenditure (being undertaken 'on behalf of' households).

Households' spending is split between tradables (65.3%) and non-tradables (34.7%); but government spending is almost entirely on non-tradables. The two sectors share spending on investment (GFCF): tradables (44%); non-tradables (56%).

The analysis above highlights the importance of public expenditure in relation to the non-tradables sector of the economy. Government is responsible for the lion's share of final demand for the non-tradables sector which itself accounts for half of pay and profits in the economy as a whole. Although the government spends almost nothing on tradables directly, the non-tradables sector makes significant purchases from the tradables sector as intermediate inputs, so government spending affects the tradables sector indirectly. By contrast, relatively little of any final demand for tradables is reflected in purchases of intermediate inputs from the non-tradables sector. This is the asymmetry referred to earlier. However, because demand for tradables inevitably includes demand for imports, there is more leakage abroad from tradables expenditure.

## Overall Impact Measures

The overall, direct and indirect, impact on total gross output (or supply) due to a change of £1 in final demand for either the tradables or the non-tradables sector is measured by the relevant Leontieff 'impact multiplier'. Values for these impact multipliers calculated for selected years are presented in Table 7. It is interesting to note that the multiplier for the non-tradables sector is consistently greater than that for the tradables sector, and that the disparity has grown steadily wider over the years.

**Table 7: Leontieff 'impact multipliers' for both sectors in various years**

(data from: SUTS 2010, ONS; calculations by me)

	1997	2000	2007	2010
Tradables	1.64	1.63	1.62	1.57
Nontradables	1.82	1.85	1.86	1.88

## Analytical Results

To sum up then: tradables and non-tradables are equally important in terms of the British economy's overall value added; sales abroad are a substantial portion of final demand for tradables; government spending makes a major contribution to demand for non-tradables; the knock-on effects of changing demand for non-tradables exceed those for tradables.

Under these conditions we can make an appraisal of Britain's economic situation in the wake of the Great Financial Crisis.

### After the Great Financial Crisis

Prior to the crisis, in 2007, £1 was worth US\$2.00 and €1.46. For comparison, average values for the pound, over the period 1975-2006, were US\$1.71 and €1.50. After the crisis, in 2010, £1 was worth US\$1.54 and €1.17. This represents a substantial devaluation of sterling leading to increased prices for British tradables, and thus encouraging a shift or rebalancing of activity away from non-tradables as a result of the squeeze applied to the relative profitability or cost-effectiveness of the non-tradables sector. And early in April 2013 sterling was being quoted at £1 = US\$1.56 or €1.20. This should mean that pressure for rebalancing is being maintained.

### The Influence of Devaluation

In principle, devaluation influences the economy mainly via the 'real income effect' caused by increased tradables prices. We hear that earnings have "failed to keep up with inflation". This results in reduced household consumption of tradables, *both native and foreign in origin*. This obviously curtails imports directly. It also allows scope for an increase in sales of British tradables abroad to offset reduced domestic demand; *but this only comes into operation in the context of expanding global effective demand*. It is this expansion and sales increase overseas that encourages the transfer of resources from non-tradables to tradables activity in Britain, the need for which has been signalled by the changing exchange rate having altered the relative prices between the two sectors.

### Making Adjustments

The depreciation of sterling makes itself felt through falls in real income (the extent to which increases in earnings fail to keep up with price increases). Table 8 is used to show how far this

process has gone: the data compares earnings at the turn of the year (2012/2013) with earnings five years ago (2007/2008, at the beginning of the crisis) and with two years ago (2010/2011, at the end of the crisis). The price changes over the equivalent periods are also shown. This allows us to assess the way real incomes have been affected in different parts of the workforce.

**Table 8: Earnings in different types of job at the turn of the year 2012/2013**  
(data from ONS)

	Earnings Now (£/wk)	vs 2 years ago (%)	vs 5 years ago (%)	% of workforce
<b>All Types of Job</b>	558	3.1	12.0	100
<b>Managers &amp; Senior Officials</b>	803	4.4	11.2	16.3
<b>Professionals</b>	766	1.7	12.2	13.6
<b>Associate Professional and Technical</b>	599	1.7	10.5	15.4
<b>Administrative &amp; Secretarial</b>	407	4.4	16.3	10.5
<b>Skilled Trades</b>	442	3.8	5.7	9.9
<b>Personal Services</b>	302	0.3	4.9	8.8
<b>Sales &amp; Customer Services</b>	328	5.8	13.9	7.3
<b>Process Plant &amp; Machine Operatives</b>	407	0.0	1.0	6.2
<b>Elementary Occupations</b>	333	5.0	6.1	11.4
<b>Price Changes (RPI)</b>		<b>7.3</b>	<b>17.0</b>	

Overall, across all types of job, weekly earnings average £558. This is 12% more than five years ago, before the crisis, but 5% less than the amount by which prices have increased over the same period (17%). This divergence of earnings and prices has continued in the aftermath of the crisis over the last couple of years and even intensified.

However, the experience in different types of job has been quite varied. At £407/wk, average weekly earnings of administrative & secretarial staff are below average; but in comparison with five years ago, before the crisis, earnings are 16.3% up, nearly enough to keep up with price changes (17%). By contrast, process plant & machine operatives (also currently on £407/wk) have earnings only 1% higher than before the crisis, and they have seen no increase at all over the last two years; so their real incomes have fallen by 16% since before the crisis. Amongst low-paid occupations: those providing personal services (£302/wk) have had a 12.1% fall in real income over the last five years; those employed in elementary occupations have had a 10.9% fall; whilst earnings of those involved in sales & customer service (£328/wk) have fallen in real terms by 'only' 3.1% (an increase in money terms of 13.9% being set against the 17% rise in prices).

In general terms, those in occupations with earnings above average levels have been better protected against price rises than those in occupations where earnings are below average. Amongst those in occupations where earnings are below average, it looks as though 'white collar' workers (administrative & secretarial staff and people engaged in sales & customer services) have fared appreciably better than the rest (who have experienced falls in real income of more than 10% since the onset of the crisis).

### Implications

The general lowering of real incomes described above will contribute to reduced domestic/household final demand or consumption in real terms. This 'income effect' on consumption will apply to both tradables and non-tradables.

For real domestic total gross output (hence employment, pay and profit) even to remain constant, as part of the rebalancing, requires that overseas final demand for tradables grows by at least as much as domestic final demand for tradables is reduced; *and in addition* by even more than the amount by which household consumption of non-tradables is reduced (this is because, as illustrated by the figures in Table 7, the knock-on impact of an equivalent change in final demand is greater in the non-tradables than in the tradables sector). But income growth in countries abroad where British tradables might expect to find purchasers is sluggish. And demand for some tradables in which Britain enjoys competitive advantage may have suffered a structural decline (e.g. financial services).

This all amounts to a recipe for stagnation. In these circumstances, consideration ought to be given to the scope for *ex tempore* enhancement of final demand for non-tradables.

### Public Finances and the Demand for Non-tradables

The analysis of Tables 4-6 has made clear the responsibility of government for the major part of final demand for non-tradables. So the government's financial situation must influence what scale of intervention is prudently permissible in terms of public expenditure.

Table 9 contains data reporting government finances, expressed in terms both of GDP and in terms of government revenue, for purposes of comparison. The UK is compared with the Eurozone and some of its constituent states as well as with the OECD as a whole and some other selected members, including especially the USA which has an important sovereign currency.

**Table 9: Governments' Financial Situation 2010**  
(data from OECD; revised calculations by me)

	Deficit	Grossdebt	Netdebt	GOV'T REVENUE	Deficit	Grossdebt	Netdebt
	(as % GDP)				(as % Gov't Revenue)		
<b>the UK</b>	<b>-10.1</b>	<b>85.6</b>	<b>53.8</b>	<b>40.1</b>	<b>-25.2</b>	<b>213.5</b>	<b>134.2</b>
France	-7.1	95.5	57.3	<b>49.5</b>	-14.3	192.9	115.8
Germany	-4.2	86.3	49.8	<b>43.6</b>	-9.5	197.6	114.1
Netherlands	-5.0	71.6	34.4	<b>46.1</b>	-10.9	155.2	74.6
Italy	-4.3	126.7	99.5	<b>46.1</b>	-9.4	275.2	216.1
Spain	-9.7	67.7	40.2	<b>36.6</b>	-26.4	185.0	109.8
Greece	-10.8	153.0	117.2	<b>40.6</b>	-26.7	376.7	288.5
<b>Eurozone</b>	<b>-6.2</b>	<b>93.1</b>	<b>57.6</b>	<b>44.8</b>	<b>-13.9</b>	<b>207.7</b>	<b>128.6</b>
Australia	-4.7	23.5	1.8	<b>31.6</b>	-14.9	74.4	5.6
Canada	-5.4	83.0	29.7	<b>37.6</b>	-14.4	220.8	79.0
<b>USA</b>	<b>-11.4</b>	<b>97.8</b>	<b>74.3</b>	<b>31.3</b>	<b>-36.4</b>	<b>312.6</b>	<b>237.6</b>
Japan	-8.4	192.7	112.8	32.4	-25.8	594.4	347.8
<b>OECD</b>	<b>-7.7</b>	<b>98.7</b>	<b>59.7</b>	<b>36.3</b>	<b>-21.2</b>	<b>271.8</b>	<b>164.4</b>

Public sector finances are usually assessed with reference to the twin measures of budget deficit and national debt. The standardised figures published by OECD are conventionally quoted in relation to the GDP of the country in question. However, the national income measured by GDP includes the private household and corporate sectors as well as the state; whereas the budget deficit and the national debt are only attributed to the public sector; so it would seem more reasonable to assess public sector deficit and debts in relation to just the income of the public sector.

Changing the basis of comparison from GDP to government revenue has interesting consequences. On the basis of GDP the UK's deficit (-10.1%) is bigger than the OECD (-7.7%) or the Eurozone as a whole (-6.2%); it's about the same as Spain (-9.7%) or Greece (-10.8%) and not far off the level of the USA (-11.8%). On the basis of government revenue however, the UK deficit (-25.2%) is much bigger than the Eurozone (-13.9%) and bigger than the OECD as a whole (-21.2%); it's about the same as Spain (-26.4%) or Greece (-26.7%) or Japan (-25.8%); but it's now shown to be substantially less than the deficit in the USA (-36.4%).

The comparison of debts is also interesting. The OECD reports two measures of national debt: gross and net. Although net debt recognises states can be owed money as well as owing it, perhaps the gross amount of debt is more relevant to market judgements of that debt's worth (as it represents shares in the income-stream of the government concerned).

Again the UK's relative position is altered by changing the basis of comparison from GDP to government revenue. In relation to GDP the UK's gross debt (85.6%) is somewhat lower than the Eurozone (93.1%) or the OECD as a whole (98.7%); lower than the USA (97.8%) and much lower than Italy (126.7%), Greece (153.0%) or Japan (192.7%). The same relativities hold for net debts assessed on this basis (i.e. vs GDP). In relation to government revenue the UK's gross debt (213.5%) is about the same as the Eurozone (207.7%), less than Italy (275.2%) or Greece (376.7%); lower than the OECD as a whole (271.8%); and very much below levels in the USA (312.6%) and particularly Japan (594.4%). Net debt assessed on this basis (i.e. vs government revenue) exhibits the same relativities.

### **The UK Government's Financial Position**

Looked at in relation to government revenue, the size of the UK's budget deficit justifies the concern with which it is being treated; and this concern would probably be more easily communicated and readily understood if expressed on this basis. Although I know it's *infra dig* to use the household budget as a paradigm for assessing state finances, it's an effective tool of communication.

Likewise, yet conversely, with government debt: a level of gross debt about double your annual income (like the UK's national debt expressed in this way) wouldn't be likely to frighten most people; especially anyone who's had a mortgage and who recognises the value of being able to live in a house, enjoying its benefits, whilst paying for it (analogous to the way we all inhabit the infrastructure of the public realm).

Of course judgements about the sustainable size of the public purse will necessarily be made in international markets and affect the price of the debtstocks which represent shares in the national state revenue-stream (just like commercial shares represent a chance to obtain dividends from businesses that are themselves basically revenue-streams e.g. Facebook). But it is pretty unlikely, or so it seems to me, that government debt will be rejected and not seen as an essential part of any portfolio assembled by a pension fund or other financial institution (and UK government stock will be particularly desirable for those companies committed to making payments, to pensioners for example, in sterling).



## UK Public Finances in Context

Tables 10-12 contain data that are more up-to-date and which put deficits and debts in historical context as well as in comparison with other countries and currency zones. The figures indicate that the UK government was in a strong financial position at the turn of the century, both in terms of the state budget (in surplus) and in terms of the national debt. Although a significant budget deficit had emerged by 2007, UK government debt was still low at the onset of the Great Financial Crisis. After the crisis, as noted from Table 9, the UK had a large deficit but an unthreatening level of debt. The most recent figures show the deficit being reduced; and although debt has increased it is still well below American and Japanese levels.

**Table 10: Governments' deficits in context (as % Government Revenue)**

(data from OECD; revised calculations by me)

	1997	2000	2007	2010	2012
<b>the UK</b>	<b>-5.8</b>	<b>9.1</b>	<b>-6.8</b>	<b>-25.2</b>	<b>-15.6</b>
France	-6.5	-3.0	-5.5	-14.3	-8.7
Germany	-6.1	2.5	0.5	-9.5	-0.4
Netherlands	-2.7	4.3	0.4	-10.9	-8.2
Italy	-5.8	-2.0	-3.5	-9.4	-6.2
Spain	-10.7	-2.5	4.7	-26.4	-22.4
Greece	-15.1	-8.7	-16.6	-26.7	-15.8
<b>Eurozone</b>	<b>-6.1</b>	<b>-0.3</b>	<b>-1.5</b>	<b>-13.9</b>	<b>-7.2</b>
Australia	0.1	3.9	5.1	-14.9	-8.6
Canada	0.4	6.7	3.5	-14.4	-9.2
<b>USA</b>	<b>-2.6</b>	<b>4.2</b>	<b>-8.6</b>	<b>-36.4</b>	<b>-26.8</b>
Japan	-12.2	-23.8	-6.2	-25.8	-29.5
<b>OECD</b>	<b>-4.9</b>	<b>0.2</b>	<b>-3.4</b>	<b>-21.2</b>	<b>-14.9</b>

**Table 11: Governments' gross debts in context (as % Government Revenue)**

(data from OECD; revised calculations by me)

	1997	2000	2007	2010	2012
<b>the UK</b>	<b>135</b>	<b>112</b>	<b>115</b>	<b>214</b>	<b>248</b>
France	136	131	146	193	203
Germany	133	132	150	198	195
Netherlands	178	139	113	155	177
Italy	274	269	244	275	264
Spain	199	174	103	185	261
Greece	257	268	283	377	416
<b>Eurozone</b>	<b>175</b>	<b>165</b>	<b>159</b>	<b>208</b>	<b>218</b>
Australia	109	71	42	74	91
Canada	217	186	163	221	228
<b>USA</b>	<b>195</b>	<b>154</b>	<b>196</b>	<b>313</b>	<b>346</b>
Japan	325	442	482	594	639
<b>OECD</b>	<b>192</b>	<b>181</b>	<b>196</b>	<b>272</b>	<b>293</b>

**Table 12: Governments' net debts in context (as % Government Revenue)**

(data from OECD; revised calculations by me)

	1997	2000	2007	2010	2012
<b>the UK</b>	<b>80</b>	<b>67</b>	<b>69</b>	<b>134</b>	<b>172</b>
France	83	70	72	116	128
Germany	72	73	97	114	112
Netherlands	107	76	61	75	91
Italy	221	211	189	216	204
Spain	144	116	43	110	161
Greece	197	207	202	289	335
<b>Eurozone</b>	<b>115</b>	<b>103</b>	<b>94</b>	<b>129</b>	<b>137</b>
Australia	62	25	-21	6	24
Canada	146	105	56	79	92
<b>USA</b>	<b>141</b>	<b>100</b>	<b>141</b>	<b>238</b>	<b>273</b>
Japan	108	192	239	348	400
<b>OECD</b>	<b>113</b>	<b>98</b>	<b>106</b>	<b>164</b>	<b>188</b>

To sum up: the situation of UK government finances, examined in appropriate context (and especially in comparison with the USA and Japan which both successfully sustain sovereign currencies), doesn't seem to preclude expenditure that would enhance final demand for non-tradables. Presumably the repeated reference made by government ministers to the desirability of expediting infrastructure projects is a form of recognition that this is the case.

### The Scope for Government Intervention

In considering the scope for government intervention (requiring additional public expenditure) it is important to bear in mind that long-run sustainable income growth will depend on continuous improvements in labour productivity (in technical language this involves 'expanding the national production possibility frontier'). Public expenditure that contributes to this improvement might even be expected to pay for itself through tax-receipts associated with increasing productive activity and sales. Enhanced public expenditure in support of workplace learning might meet this objective. For example, there has been widespread concern regarding the need for a greater degree of humanitarian awareness within the provision of health and social care. Programmes of training that raise the quality of care delivered in this way would fit the bill. By involving universities, colleges and schools, to provide independent facilitation of appropriate learning events, initiatives of this sort would use increased final demand in one part of the non-tradables sector ( education) to improve productivity elsewhere in the non-tradable sector (health and care services). Suitable programmes might be funded directly or via tax concessions.

### Vested Interests and Political Paralysis

Could even more be done? It's understandable that there should be a precautionary attitude in relation to public finances. However, when the government 'bailed out' the banks, it gave them the money immediately, in return for shares that will be sold at a future date (thus recouping the cash in the long term). So why shouldn't the same principle apply in the short term? Construction is

quintessentially non-tradable: why doesn't the government just commission some house-building from house-builders, and recoup the money by selling the houses at auction? If the time between placing the order and holding the auction was inside a financial year, there wouldn't even be any addition to the budget deficit or national debt.

Of course the construction industry might consider that making money from building houses was their prerogative. And trade unions representing public administration workers might say that public money should only be spent on social housing requiring public administration. Might such vested interests exercise influence within established political parties? And would this encourage an unspoken alliance to sabotage my proposition?

It's the expectation that "there'll be a reason why it can't be done" which keeps most of us out of politics. Recognising the powerless condition of modern living, frustrated in the belief that common understanding can be established, depressed by the paralysis of parliamentary practice and the institutions of government: *anomie* is the answer; the only rational response. And yet, in my opinion, there are things that could be done and should be done (by that universal 'someone else' that is the government): building houses for sale is certainly one.

### Official Miscomprehension

A significant obstacle to appropriate political debate is official miscomprehension surrounding the economic impact of a changing exchange rate. There is a widespread belief that devaluation causes domestic output (especially 'exports') to become cheaper relative to foreign supplies (of 'imports'). It doesn't.

As explained at the beginning of this essay, the relative prices that change as a consequence of devaluation are those of tradables (domestic **and** foreign) *vis-à-vis* non-tradables (entirely domestic). They are **not** those of imported tradables *vis-à-vis* domestic tradables. The Monthly Review of External Trade Statistics (published by the Office for National Statistics on January 15<sup>th</sup> 2013) reports the prices of UK Traded Goods as per Table 13.

**Table 13: Prices of tradables across the Great Financial Crisis**  
(data from ONS)

	Prices of UK Traded Goods Exports (index)	Prices of UK Traded Goods Imports (index)
2004	84	82
2005	87	85
2006	88	88
2007	88	88
2008	100	100
2009	101	102
2010	108	108
2011	116	116

The figures in Table 13 show that the devaluation of sterling which took place in the aftermath of the Great Financial Crisis (i.e. a 20% fall in the exchange rate between 2007 and 2010) was faithfully reflected in the prices of both exports and imports (i.e. increasing each set of tradables prices to the equivalent degree).

This observation is important because it contradicts the presumptive view at the Office for Budget Responsibility - responsible for making official assessments of the country's economic prospects - hence at HM Treasury and across government as a whole. And I've lost count of the times someone's said on 'The News' that "devaluation makes our exports cheaper" (it really doesn't: the evidence is clear).

This official misconception leads to erroneous expectations of an automatic post-devaluation increase in export sales, even in the absence of greater aggregate global effective demand, so fuelling domestic economic recovery. It miscasts rebalancing of the British economy as between 'imports' and 'exports' instead of, as correctly, between tradables and non-tradables.

Overseas demand, in the absence of an *ex tempore* government addition to final demand, is the only source of extra sales generating greater overall economic activity in Britain. A recovery in growth of incomes abroad might, in principle, occur at any moment. And when it does it might be speedy. In practice signs are few and far between across Europe and America.

The only real impact of devaluation on overseas demand is to make British non-tradables (as opposed to tradables) more attractive to foreigners. Most obviously this benefits tourism. And tourism has many dimensions beyond sightseeing ('health tourism' for example, maybe also fostered by global advertising at the London Olympics). But there are many institutional restrictions surrounding domestic expansion of these areas, as well as capacity limitations (e.g. airports and associated transport links). This area of activity should require the attention of government and might also involve public expenditure.

## **Conclusion**

The prospects are bleak. It's only the knowledge that the darkest hours precede a dawn that provides any grounds for optimism. This is a sorry state of affairs.

Despite unquestioned political commitment to maintaining sterling as a sovereign currency, the significance and implications of exchange rate movement are misunderstood in official circles (and more widely). This hampers discussion of economic policy; as does mis-appreciation of the state's financial position. Valid opportunities for government intervention (e.g. to foster workplace learning, or to build houses for sale) are ignored.

It is nevertheless true that an unexpected and speedy recovery of international income growth, in reaction to changing global circumstances, is always possible; and such a development would probably benefit the UK sufficiently to distract attention from present difficulties.

Searching for straw in the wind: it's possible that a fall in world prices for tradables might, by meaning that real international purchasing power was enhanced, restore growth to global tradables demand. This would finally deliver scope for the UK tradables sector to expand exports and provide the platform for a sustained British economic recovery. A substantial global grain harvest could seed this process of global tradables price reduction (although, given the weather that we've had, Britain isn't likely to contribute to this). Surely fair weather and good harvests must be amongst the most ancient of prayers?