



The Jimmy Reid
Foundation

The Mismanagement of Britain

A record of the UK's declining competitiveness - and its
implications



Jim Cuthbert

April 2013

The Mismanagement of Britain

A record of the UK's declining competitiveness - and its implications.

**Jim Cuthbert
April 2013**

Dr Jim Cuthbert is a former government statistician, who worked in the Scottish Office and the Treasury, and was latterly Scottish Office Chief Statistician. He is a former member of the World Bank/OECD expert group on international purchasing power comparisons, and is joint author of an OECD handbook on purchasing power parities. He is the author of several published papers on technical aspects of international purchasing power comparisons. He has also written extensively on various aspects of Scotland's public finances.

Summary

This report examines the suggestion that the UK economy is strong and competitive. By looking at key indicators of competitiveness (real exchange rates, balance of payment statistics) it concludes that in fact:

- UK has experienced a long run decline in its general international competitiveness – not just against the emerging economies of the Far East, but also against other advanced economies.
- UK has experienced particularly marked short-term fluctuations in its competitiveness suggesting it is particularly exposed to external economic 'shocks'
- There has been an increasing deficit in the UK trading account in general goods and services.
- This deficit has been funded from two main sources; North Sea oil revenue in the 1980s and reliance on the financial sector since the 1990s.
- In effect, the UK economy has become like a very large bank, with international assets and liabilities which are very large in relation to the size of the economy, at over 700 per cent of GDP.

The report then examines these findings to make an assessment of the real state of the UK economy. It finds:

- The performance of the UK reflects chronic, long-term mismanagement of the economy.
- The UK is far from having the characteristics of an optimal currency area.
- The present model of the UK economy is unsustainable, with a high likelihood of a potentially catastrophic crisis in the not too distant future.

This strongly implies major policy failures over much of the last 40 years:

- In three periods (the late 1970s, the late 1980s, and from about 2002 to 2008), the exchange rate was allowed to appreciate even though internal price levels were rising significantly. Policy-makers appeared blind to the resulting loss of competitiveness and its impact on the manufacturing base of the economy. This seems to be the result of misguided pride in having an apparently strong currency.
- Policy makers seem to have missed the point that the underlying balance of trade in goods and services, which had been flattered for a time by oil revenues, was deteriorating rapidly: and that the deficit was being covered by borrowing, and by current income, both largely dependent on the financial sector.
- Policy-makers appear not to have appreciated what risks the financial sector might pose to the economy, and how unstable the tax revenues derived from the financial sector might be.
- Decisions were regularly taken with the primary focus of benefiting or protecting the financial sector, but which were not in the interests of the wider economy

- Any economy which had, as the UK economy did in 2009, a public sector deficit equivalent to over 11 per cent of GDP can hardly be called well managed.

There are immediate risks for Britain resulting from this mismanagement:

- The general economy has been weakened by using the financial sector as a prop, so the general economy is likely to be too weak to be used as an effective support, if and when the financial sector hits trouble.
- This means the present model of the UK economy is at serious risk of not being able to cope with any further serious shock to the financial sector.

But there are strong reasons to assume another serious shock to the financial sector is likely. For example:

- To give an example of just how exposed the UK economy is to credit risk, almost a quarter of the UK economy's external assets consist of financial derivatives: these financial derivatives themselves are of a magnitude equivalent to 240% per cent of UK GDP.
- The threat of a liquidity risk for Britain is no longer only theoretical; confidence among international investors in the UK economy is deteriorating, as we have seen by the credit downgrade.
- And since Britain is particularly sensitive to external shocks and since the unstable state of the world economy means such shocks are almost inevitable, the current model of the UK economy is unlikely to be sustainable.
- The assets and liabilities of the British economy double every nine years relative to GDP. This rate of growth cannot continue indefinitely. When this growth does stop the income of the City of London from managing this growth will drop rapidly.

The overall conclusion is that the present model of the UK economy is inherently unstable, and is at severe risk of imposing further substantial burdens on the long suffering UK taxpayer, and quite possibly of collapsing altogether. Had taxpayers been aware of how the economy was being developed, and had there been proper democratic accountability in the UK, it is extremely unlikely that the taxpayer would have signed up to underwriting this model.

In the light of this analysis, nationalist strategy on the 2014 referendum needs to be rethought, and current tactics reversed. The UK will always remain a primary trading partner for Scotland: so UK economic instability will always affect Scotland. But what nationalists should be pointing out is how independence could potentially insulate Scotland from the worst effects. It also strongly suggests that Scotland should not remain in a sub-optimal currency union which has sacrificed productive economy growth for conditions that suit financial speculation.

Finally, given that the next acute phase of the UK economic crisis may not occur until after the referendum in 2014, if Scotland remains in the union it should maintain the capacity to reconsider that decision.

Introduction

This paper is a contribution to the debate about the forthcoming Scottish referendum: but, paradoxically, it is not primarily about Scotland. Apart from the last section, none of the analysis relates to Scotland. What the paper is concerned with is the performance of the UK economy. What it does is to analyse important aspects of UK economic performance over the lengthy time period since just after the end of the Second World War, in terms of data on international competitiveness, and data on the UK's international accounts.

The first two sections of the paper consist of a factual analysis of the data. This part of the paper is descriptive: it is not concerned with cause and effect, or drawing out implications. What the data shows is that the UK has experienced a long run decline in its general international competitiveness – not just against the emerging economies of the Far East, but also against other advanced economies. Moreover, the data demonstrates that the UK has experienced short term fluctuations in its competitiveness, mainly driven by exchange rate instability, which have been greater than for many other advanced economies. The counterpart of the UK's declining competitiveness has been the emergence of an increasing deficit in the UK trading account in general goods and services. This deficit has been funded from two main sources. First of all, in the early 1980's, by the revenues from North Sea oil: and latterly, by increasing reliance on the financial sector. In the process, because of its increasing reliance on the financial sector, the UK has turned itself into what is effectively a very large bank, on a scale which far exceeds any other large economy: by 2011, both the international assets and liabilities of "Bank UK" were each of a magnitude exceeding seven times the UK's gross domestic product, and were growing fast.

The next section of the paper looks at implications of this situation for the UK as a whole. Three main conclusions are drawn. First, that the performance of the UK reflects chronic mismanagement of the economy. Secondly, that the UK, viewed as a currency area, is far from having the characteristics of an optimal currency area. And third, that the present model of the UK economy is unsustainable, with a high likelihood of a potentially catastrophic crisis in the not too distant future.

The final section of the paper looks at the implications for Scotland – and is the only part of the paper which deals specifically with Scotland. There are profound implications for the referendum. The debate so far has largely been conducted against the implicit assumption of the continued strength and stability of the UK economy. This has, naturally, been the position put forward by the unionist side of the argument. But surprisingly, it has also been the position taken by some nationalists: the SNP, for example, have argued that the UK is an optimal currency area, and want an independent Scotland to retain membership of a UK currency union for the foreseeable future. This tactic makes no sense in the light of the weakness and instability of the UK economic model, and should be reversed. Far from implicitly accepting the strength of the UK economy, nationalists should be adapting their thinking to the implications of the UK's economic problems: they should be stressing the UK economy's weakness and instability: and, in particular, they should be developing a strategy which points out the benefits of Scotland ultimately having its own currency.

The implications, however, go even deeper, and have something very important to say about the very status of the referendum. The referendum is being conducted under the terms of the Edinburgh Accord, signed between David Cameron and Alex Salmond. The final clause of this accord states that both parties will be bound by the referendum result. Now imagine that there was a 'No' vote in the 2014 referendum: also imagine that a few years later the UK suffered the profound economic crisis which, as the analysis in this paper suggests, is likely. It is unclear what will emerge from such a crisis, either in terms of the economic structure of the UK, or the political complexion of the regime at Westminster. What is quite clear is that it would be perfectly

proper for Scotland, at that stage, to ask itself if it wanted to continue in the direction in which the rest of the UK was travelling. But if Scotland did this, the final clause of the Edinburgh Accord would be used to stop any move towards Scottish self determination. What this indicates is the nonsensical nature of the final clause, which should neither have been offered nor signed, and which should now be declared a dead letter. Scotland doesn't need that clause to secure the right to self determination: but the clause could cost Scotland dearly.

Section One: Competitiveness of the UK economy.

It is well known that exchange rates in themselves are not a good indicator of relative price levels between countries. If you were to convert pounds into euros at the exchange rate, and then use the euros to buy a coffee in Paris, you are liable to feel that, in terms of the pounds you have spent, the coffee was relatively cheap, or perhaps dear, compared with what you might have spent on a similar coffee in London. To enable accurate international comparisons to be made, statisticians and economists have devised standard measures, known as purchasing power parities, of the relative internal price levels between different countries. Considerable international effort has now been put, both into devising the appropriate methods for calculating purchasing power parities, and into collecting the required data. The most extensive database on purchasing power parities and related data is that which grew out of the United Nations International Comparisons Project, and is published by the University of Pennsylvania as the Penn World Tables: (PWT 7.1)

Data on exchange rates and purchasing power parities can be combined together to form a standard measure of the relative competitiveness between different economies, known as the real exchange rate. This is formally defined in the Annex.

Intuitively, the real exchange rate between country A and country B can be regarded as the number of standard baskets of goods in country A, which could be purchased for the price of one standard basket in country B.

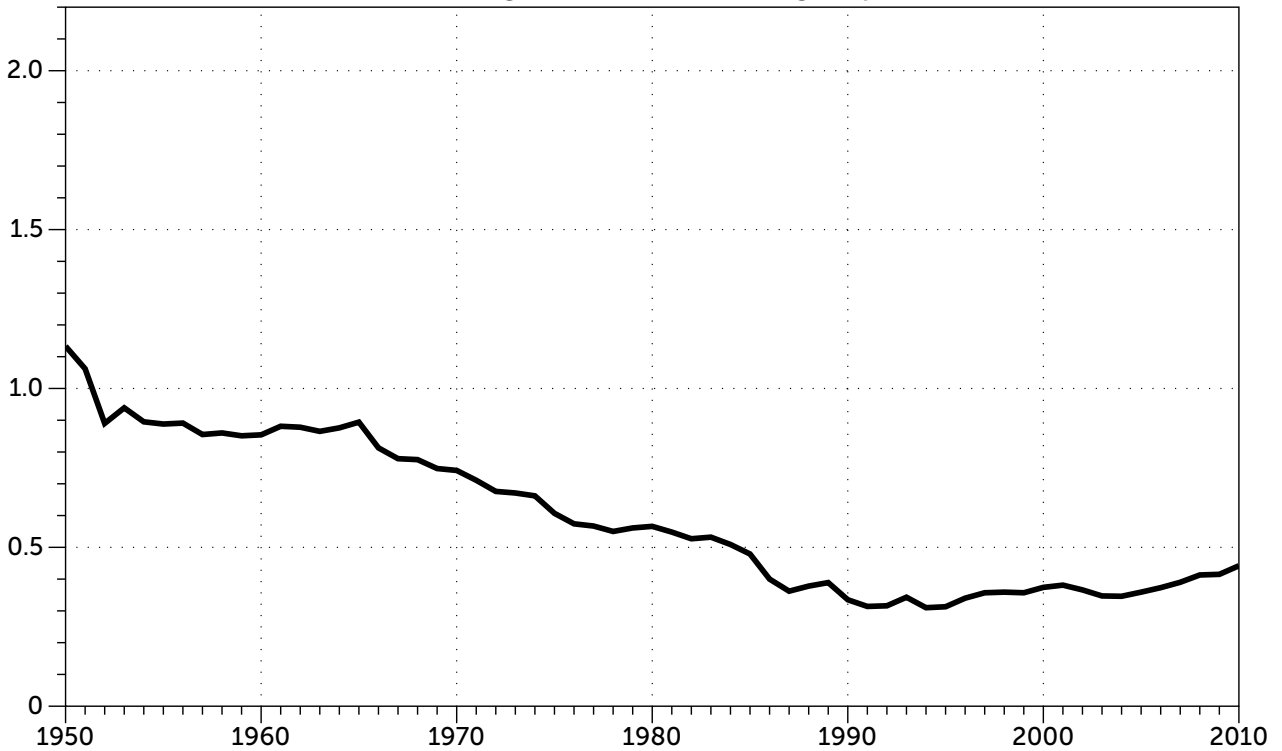
The real exchange rate has the following features. Suppose that the real exchange rate of country A relative to country B is greater than one: then this means that prices in A are relatively lower than those in B, which implies that, (other things being equal), A is likely to be a more attractive economy in which to purchase goods or services, or to set up business: that is, A is likely to be more competitive than B.

Now suppose that inflation is higher in A than B: then the real exchange rate falls, that is, A loses competitiveness relative to B. However, if there is a depreciation of the currency of A relative to B, this will raise the real exchange rate: that is, it will increase country A's competitiveness relative to B.

For the purposes of the present paper, data for 149 countries on purchasing power parities, exchange rates, and GDP on a common price basis, and for the period 1950 to 2010, were taken from the Penn World Tables, Version 7.1: (PWT 7.1). This data was used to calculate time series of real exchange rates between individual countries, between individual countries and country groups, and between groups of countries.

To put the later discussion of the UK's competitiveness in context – and to show that the real exchange rate, as a measure of competitiveness, does indeed capture recognisable trends in the world economy – it is worth looking first of all at trends in the real exchange rate between two major groups of countries. Consider two country groups: a group of 27 advanced economies, (principally consisting of the North American and Western European economies, with Japan and Australasia), and a group of nine emerging Asian economies, (including China and India). Then Chart 1 illustrates the real exchange rate of the advanced group, relative to the emerging Asian group, over the period 1950 to 2010.

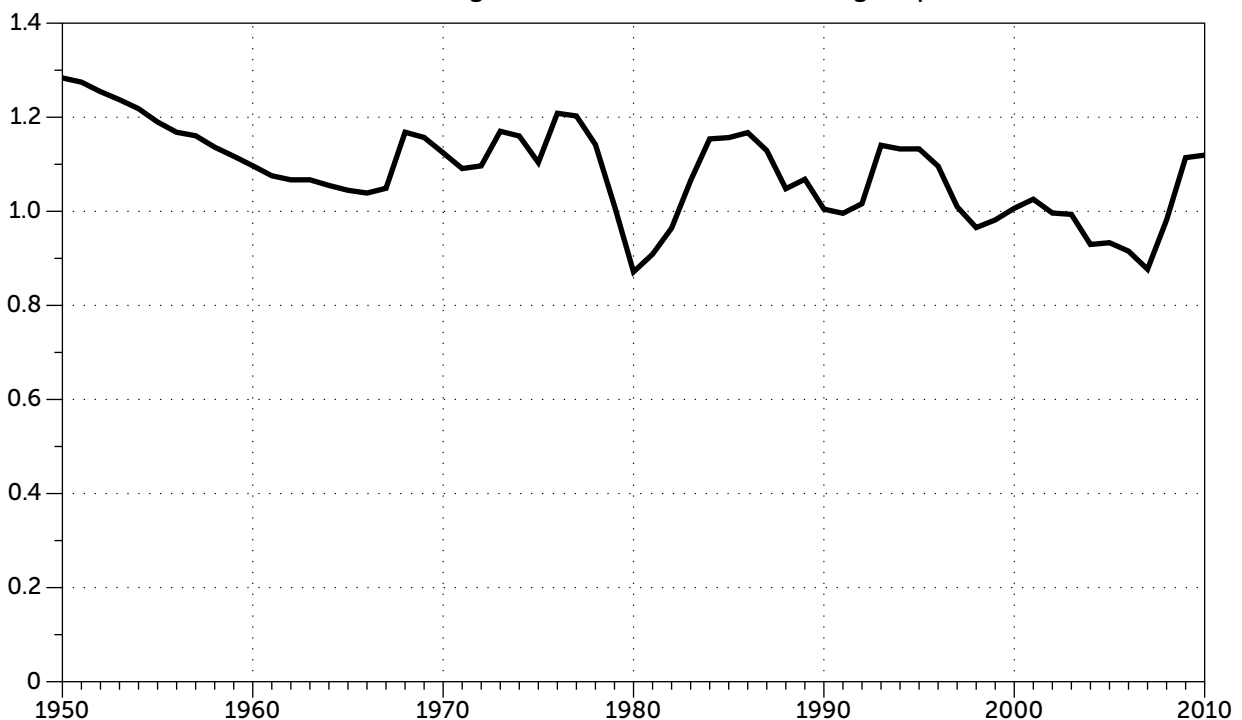
Chart 1: Real exchange rates - advanced group relative to Asia



The most noteworthy feature of this chart is the consistent decline in the competitiveness of the advanced economies relative to the Asian group through most of the period up to the early 1990's. The current marked competitive advantage of the Asian group is, of course, reflected in the way they have taken over a large part of the world's manufacturing.

Now consider what has been happening to the real exchange rate of the UK relative to the group of countries most closely resembling the UK, namely, the advanced economy group. This is illustrated in Chart 2, which shows the competitiveness of the UK relative to the advanced economy group as a whole, from 1950 to 2010.

Chart 2: UK real exchange rate relative to advanced group of countries



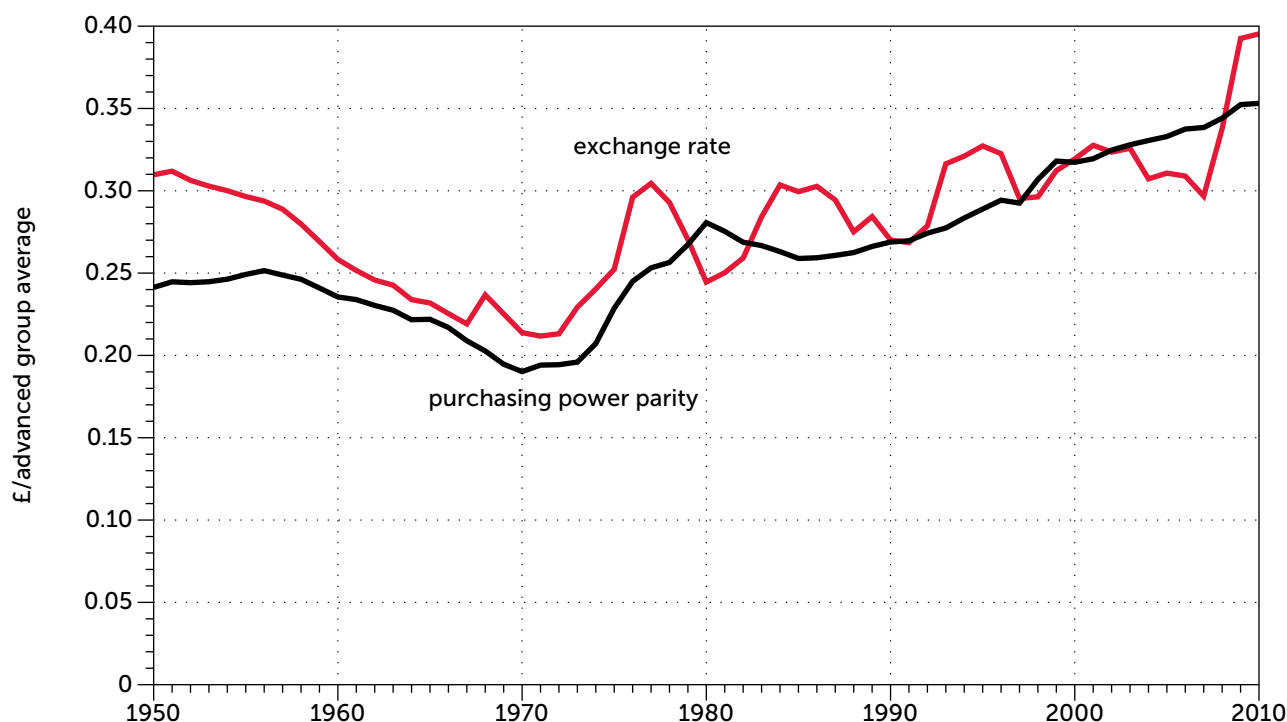
The overall picture is not an encouraging one. The UK's competitiveness relative to the advanced group of countries declined steadily, and rapidly, from 1950 until 1967. From 1967, there is a change in behaviour: the jaggedness of the chart post 1967 shows how the UK's competitiveness has been subject to marked swings, typically over a time horizon of some two to five years. The absolute low point over the period occurred in 1980, at the trough of a particularly large swing. Despite these swings, however, the overall trend has been downwards until 2007. This picture is relieved by the sharp increase in competitiveness in 2008 and 2009: but it is too soon to say whether this is just another temporary spike.

It is natural to ask whether other economies were like the UK in experiencing rapid fluctuations in competitiveness. Suppose the G7 group, (Canada, France, Germany, Italy, Japan, UK and USA), is taken as being typical large advanced economies. Then analysis of the data shows that the UK has been consistently in the bottom half of G7 economies as regards the volatility in its real exchange rate over horizons of two, three or four years. This volatility is a worrying feature of the UK economy: while an economy may be able to adapt to long term changes in relative competitiveness, it may well find it extremely difficult to adapt to sharp changes in competitiveness in the short term.

Analysis of the data also shows that, while many economies show a greater degree of volatility in their competitiveness than the UK, some small economies, like Norway, Switzerland, and Denmark (each of which happens to have its own currency), have consistently shown less volatility in their individual competitiveness than the UK, and less than most other advanced economies.

To better understand some of the factors underlying the changes in UK competitiveness observed in Chart 2, it is useful to decompose the UK real exchange rate (relative to the advanced countries) into its separate exchange rate and internal price components. These are shown in Chart 3. The real exchange rate in Chart 2 is the exchange rate component in Chart 3 divided by the purchasing power parity component.

Chart 3: Exchange rate and purchasing power parity components of real exchange rate of UK relative to advanced group



As can be seen immediately from Chart 3, most of the short term volatility in UK competitiveness has stemmed from volatility in the exchange rate. This short term volatility was largely absent

prior to 1971. This was because, up to that point, the UK was a member of the Bretton Woods system, with its currency tied to the dollar. Over the period illustrated, the only sharp fluctuation in the exchange rate prior to 1971 was the Harold Wilson devaluation of 1967, which shows up in Chart 3 as the sharp peak in the exchange rate component in that year.

After the end of Bretton Woods, the exchange rate is markedly more volatile. Note the rapid relative depreciation from 1971 to 1977, and the associated rapid rise in internal price levels in the 1970s, resulting from the very high rate of UK inflation during this decade. Also very noticeable are the sharp depreciations in the currency associated with the UK's exit from the Exchange Rate Mechanism in 1992 (it had joined in 1990) and following the financial crisis of 2008: these account for the sharp peaks in the exchange rate component at these times.

Perhaps the most interesting features of Chart 3, however, are those periods, (particularly from 1977 to 1980, but also from the mid-1980s to 1990, and from 2002 to 2008) when internal price levels in the UK were rising – but at the same time the UK currency was appreciating (that is, the exchange rate line in Chart 3 was falling). It was the first, and most marked of these episodes (from 1977 to 1980) which led up to the low point in the UK's international competitiveness throughout the whole period from 1950 to 2010: which, as has been seen in Chart 2, occurred in 1980. Normally, it would be expected that an increase in the UK's internal prices would be associated with a worsening in the UK's trade position, and hence with a weakening of the currency. The anomalous position during each of these three periods, when the currency was appreciating despite a relative increase in internal price levels, suggests that in each of these periods some other factor was at work.

What other factors were at work during these three periods will be examined in the next section, which looks at what was happening to the various trade and financial flows which make up the external accounts of the UK. In summary, the main messages to be taken from the current section are, first, the overall declining trend in UK competitiveness relative to the advanced group of countries, throughout the long period studied: and also the short term volatility in UK competitiveness, associated with the volatility of the exchange rate in the period since the end of Bretton Woods.

Section Two: The UK's International Accounts.

The subject of this section is the various flows which make up the international accounts of the UK. Detailed information on these accounts is published annually by the Office for National Statistics (ONS) in what is known as the "Pink Book": (ONS 2012).

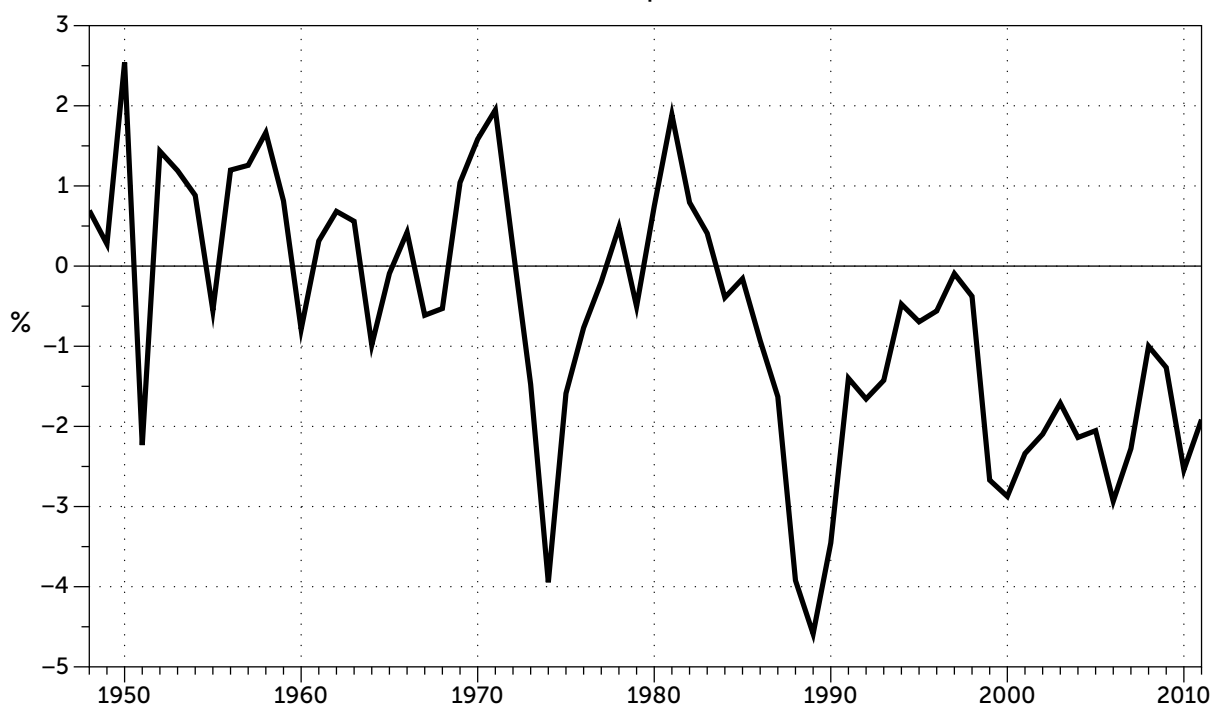
In these international accounts a basic distinction is drawn between the current balance, and the balance on the capital and financial account. The most important element of the current balance relates to trade in goods and services: but there is also a significant element relating to income (for example, dividend earnings on securities held abroad by UK residents, or held in the UK by foreign residents) and there is an element relating to transfer payments (like the UK's payments of international aid, or subscriptions to international organisations). The net balance on all current flows is the UK's current account surplus (if positive) or the UK's current account deficit (if negative).

If an economy becomes uncompetitive, then domestic firms will find it difficult to export: and, conversely, imports will become relatively cheaper. So it might be expected that there would be a strong correlation between the competitiveness of an economy and the size of its current account surplus, or deficit. While this is true in general, the position is not quite as simple as this. The measure of competitiveness examined in the last section is essentially based on an average

price level for the whole of the production of an economy – that is, for the whole of GDP. Such a measure does not necessarily indicate the competitiveness of the economy in what might be key export sectors. So an economy which appeared uncompetitive on its general prices might still be doing very well in terms of its overall trade balance, because it had a price advantage in some specific sector or sectors. Hence, on occasion, it is necessary to look below aggregate figures on the current surplus or deficit, to understand exactly what is going on in an economy.

Chart 4 shows the current net surplus/deficit of the UK, over the period 1950 to 2011; in order to be able to compare relative magnitudes over this very long time period, and to give an indication of quantities relative to the size of the economy, the figures for each year have been expressed as a percentage of that year's GDP. (The data used in compiling these charts were taken from the ONS Pink Book 2012 dataset, with the exception of figures for UK gross domestic product at current prices, which were taken from the ONS Blue Book 2012 dataset.)

Chart 4: UK current net surplus/deficit as (% GDP)



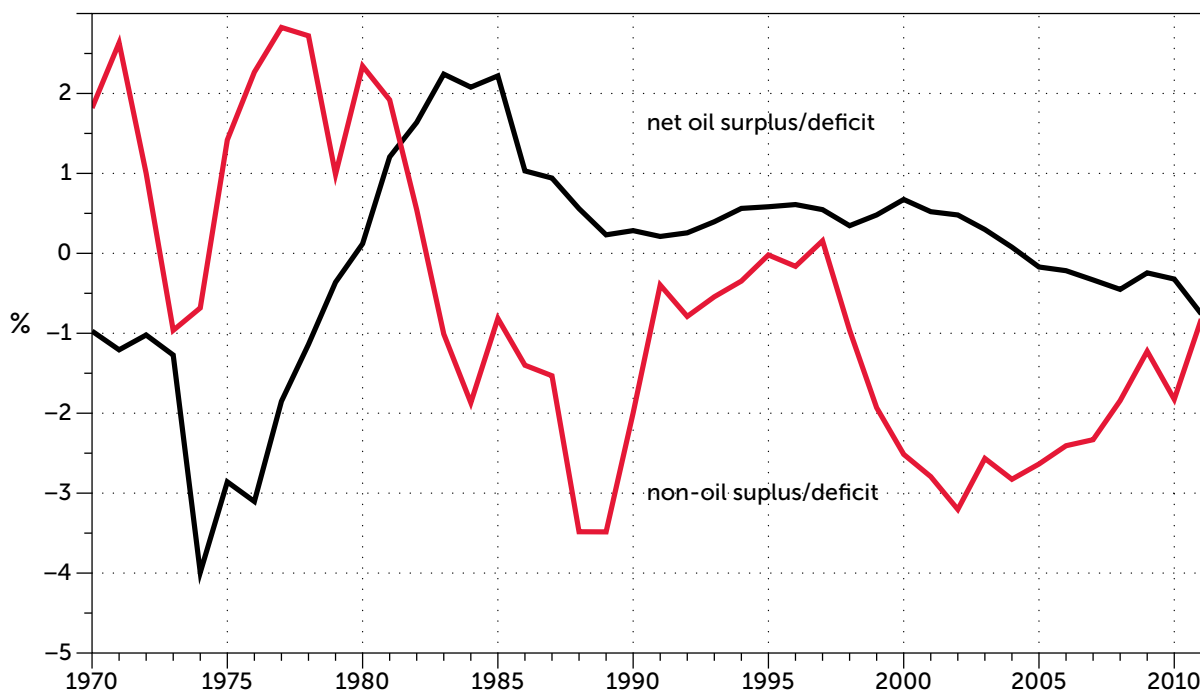
There is indeed a broad correspondence between this chart, and the picture of the competitiveness of the UK economy given in Chart 2. Just as the competitiveness of the UK economy has generally worsened over the period, so the current account has trended from surplus to deficit. More specifically, there is a very large deficit in 1989, which corresponds to the local low in UK competitiveness around 1990: and during the period 2000 to 2008, there is a large continuing deficit, which corresponds to the trough in UK competitiveness from 1997 to 2008.

Despite these correspondences between the overall pictures for competitiveness and deficit, there are three particular features of Chart 4 which stand out as potential anomalies. Two of these are the large deficits in 1951 and 1974, which occurred at times when, on the basis of Chart 2, the UK was relatively competitive. The other potential anomaly is the position in the early 1980s, when the UK was overall in strong surplus, even though at that time it was experiencing its worst dip in competitiveness as measured in Chart 2.

The 1951 deficit was largely caused by specific factors relating to the Korean War. The explanation of the 1974 anomaly is that this was when the UK was experiencing the industrial unrest that culminated in the three-day week: with the factories only running part time, it is not surprising that the current deficit was large.

To understand what was happening in the early 1980s it is necessary to look below the surface of the overall deficit figures. The early 1980s were, in fact, the peak of North Sea oil production. Chart 5 shows two important components of the overall current deficit: namely, the net surplus or deficit on trade in oil, and the net surplus or deficit on trade in goods and services other than oil (again expressed as percentages of GDP).

Chart 5: UK net surplus/deficit on trade in oil and trade in goods and services other than oil, (% GDP)

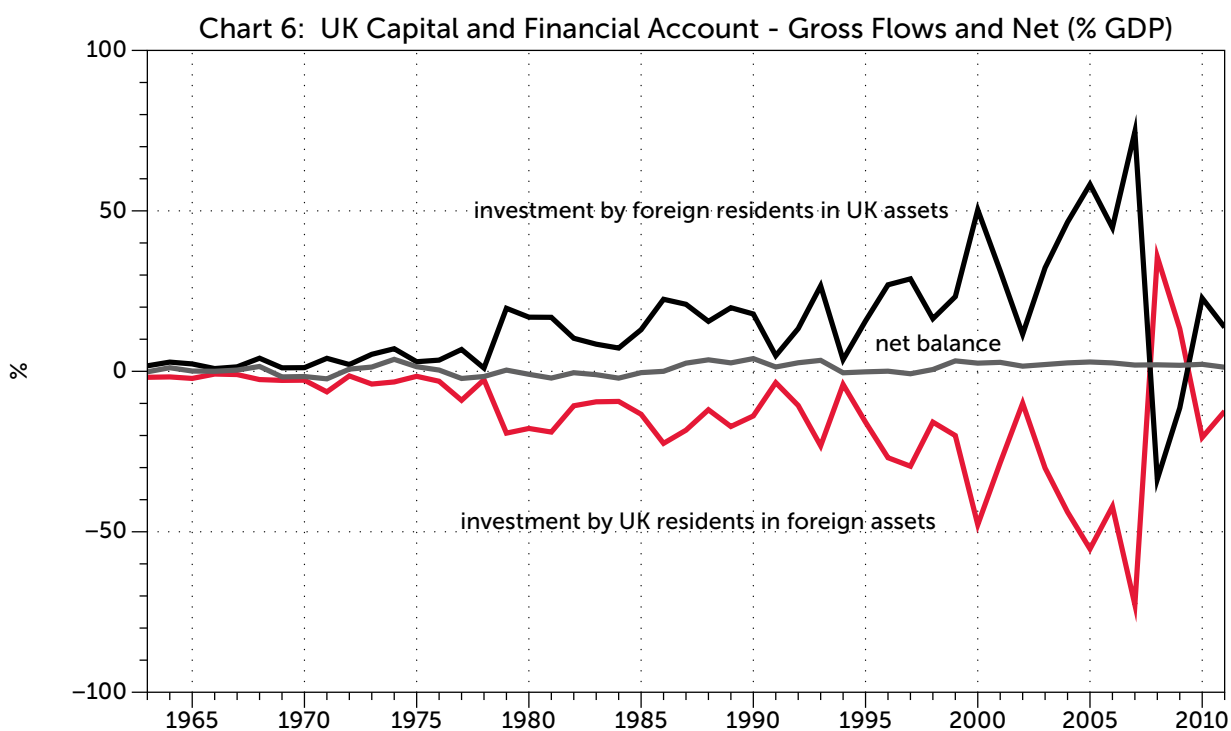


The picture in Chart 5 is very striking. Throughout the 1980s, there was a very steep worsening in the UK's surplus/deficit on trade in goods and services other than oil: from a surplus of over two per cent of GDP in 1980 to a deficit of almost 3.5 per cent in 1989. Over the period from 1980 to 1985, there was a strongly increasing surplus on trade in oil. The upshot is that the apparently healthy overall current surplus of the UK in the early 1980s was the result of a surplus in oil concealing a marked decline in the trade position on non-oil goods and services.

So, in the early 1980s, the UK was in effect using its oil reserves to fund its increasing deficit in trade in goods and services apart from oil.

How did the UK fund its current deficit in the 1990s and 2000s? To understand this, it is necessary to look at the other side of the international accounts, dealing with capital and financial flows.

Because of the double entry system used for compiling the UK's international accounts, any surplus or deficit in the UK's current account must have as its counterpart an equal and opposite flow of funds in the capital and financial account. (In fact, in practice equality does not quite happen, because of various errors and omissions in estimating the separate elements of the accounts: but the basic principle remains.) So if the UK is running a current account deficit, there must be an associated inflow on the capital and financial account: in other words, the UK's net indebtedness to the rest of the world must have increased by this amount. This net position, however, is the difference between two potentially very large quantities: that is, it is the difference between the amount UK residents have invested in foreign assets (a financial flow out) and the amount foreign residents have invested in UK assets (a financial flow in). Chart 6 shows these gross flows for the UK, expressed as a percentage of GDP, together with the corresponding net balance (that is, the difference between the two gross flows).



Looking at the “net balance” line in Chart 6 first of all, this shows exactly the position which would be expected, given the picture of the current net deficit in Chart 4. As the counterpart to the net current account balance, the net balance on the capital and financial account has moved from basically negative to positive over the period: and has been particularly high in the late 1980s and early 1990s, and since 1999.

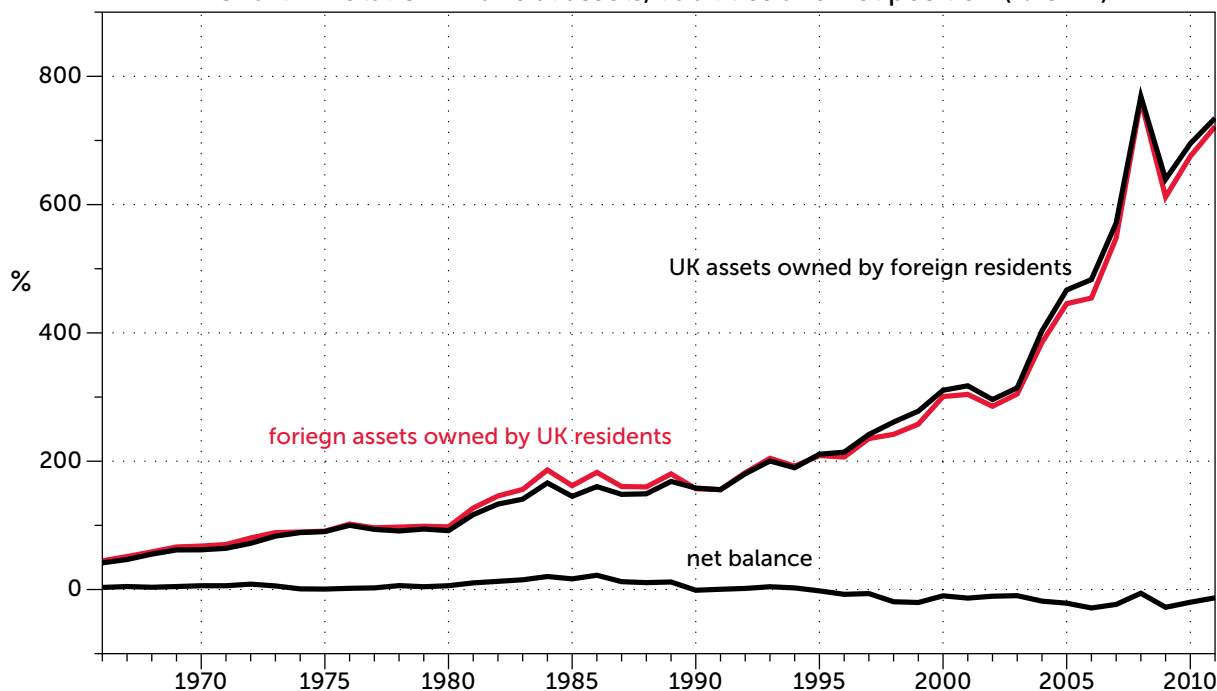
What is really noteworthy about the chart, however, is the magnitude of the two gross flows which have resulted in this overall net position. Up until 1978, each of these gross flows was relatively modest as a percentage of overall GDP: neither flow exceeded 10 per cent of GDP over this period, and usually the flows were much smaller. In the early 1980s, however, the picture changed: from then until 2007, despite some fluctuations, there were very rapid increases both in the acquisition of foreign assets by UK residents, and the acquisition of UK assets by foreign residents. Both flows ultimately became huge – both being of a magnitude equivalent to more than 70 per cent of UK GDP by 2007. (It is important to stress that the figures in Chart 6 are expressed as percentages of GDP: so the growth in the gross flows observed in Chart 6 is indeed a real phenomenon, and does not in any sense represent an increase in nominal values due to inflation.)

What has accounted for these very large increases? When Steve Nickell (at that time a member of the Bank of England’s Monetary Policy Committee) examined the situation in 2006 (Nickell, 2006) he pointed out that these increases represented the activities of the UK financial sector: that is, to a large extent, the City of London. The UK financial sector, as Nickell pointed out, “plays an important intermediary role in a high proportion of the World’s financial transactions”. Effectively, the financial sector has been taking in extremely high volumes of funds each year from foreign residents, and re-investing these funds in the acquisition of assets abroad. It is this feature which accounts for the striking mirror image effect in Chart 6, with the acquisition of foreign assets by UK residents rising or falling in line with the acquisition of UK assets by foreign residents. It is also very striking how purchases of foreign assets by UK residents were positive for each year through the 1980s, 1990s and most of the 2000s – until the crisis in 2008, when UK residents greatly reduced their holdings of foreign assets (and foreign residents greatly reduced their holdings of UK assets) leading to the dramatic crossover in 2008 evident in the chart.

Since UK residents have been adding to their holdings of foreign assets by huge amounts each year (with the exception of 2008 and its immediate aftermath) it follows that the total stock of

foreign assets held by UK residents must have been growing strongly: (as, conversely, will total stocks of UK assets held by foreign residents). This is indeed the case, as is illustrated in Chart 7, which shows the relevant figures since 1966, again as a percentage relative to the size of UK GDP.

Chart 7: Total UK financial assets, liabilities and net position (% GDP)



As can be seen, the UK's net asset position, on this basis, has moved from being basically positive before 1990 to being basically negative thereafter. It has to be said, however, that the net asset position might still be positive if all asset values were expressed at market rather than book values. So the negative net asset position recorded in the chart is not necessarily in itself a cause for concern. (In the international accounts, some assets, like some major investments in companies, are valued at book value, rather than market value. Book value is based on the price paid for the asset, rather than current market value.)

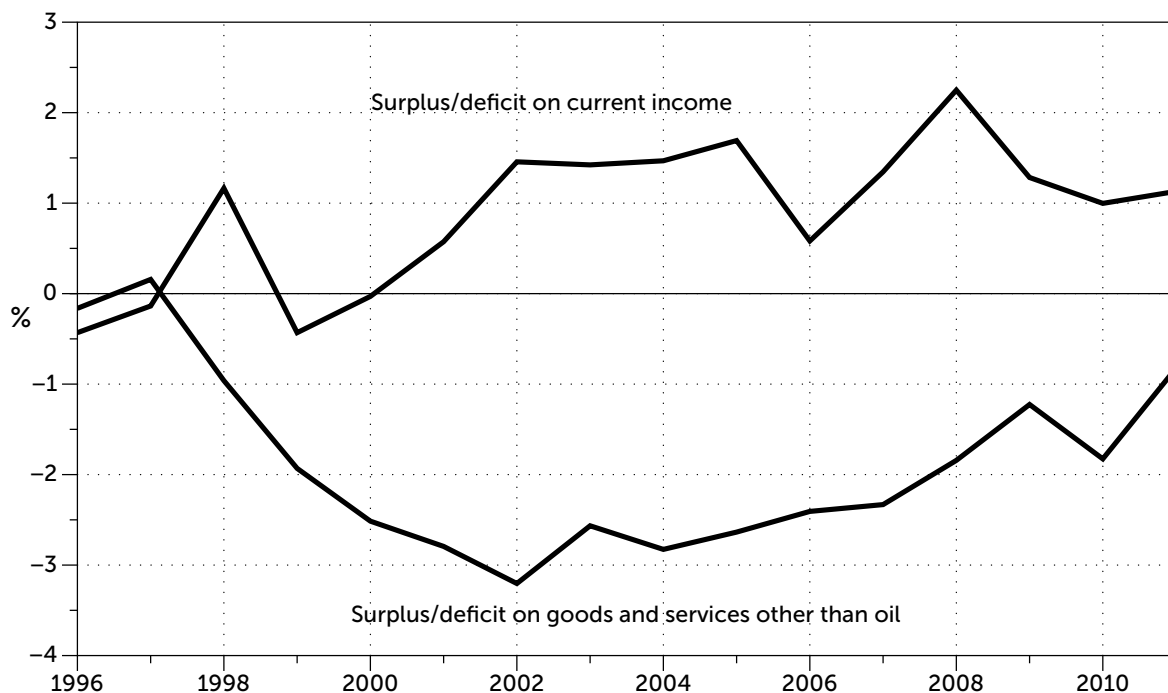
However, what is really extraordinary about the picture recorded in Chart 7 is the size, and the rate of growth, in the gross asset figures – particularly over the last decade. (Again, it is important to stress that, since the figures in Chart 7 have been expressed as percentages of GDP, the growth in Chart 7 is primarily real growth, and is not the result of inflation.) In 2005, the stock of foreign assets owned by UK residents was just less than 450 per cent of UK GDP: by 2008, this figure had increased to 760 per cent: and despite the subsequent drop, growth had resumed again, to 730 per cent, by 2011. (There is in fact a discontinuity in the series in 2010, because at that stage the ONS included for the first time a particular group of financial derivatives: but even allowing for this, the return to growth in these figures post 2008 is marked.)

It is important to note that the size of UK assets and liabilities is remarkably large by international standards. Writing about the position as it was in 2005, Nickell (Nickell, 2006) commented "Relative to GDP, the size of these stocks of foreign assets and liabilities is far higher in the UK than in any other country". And this comment was made before the relative size of these stocks increased by more than half as much again between 2005 and 2011.

Nickell also noted that there had been significant differences in the types of foreign assets held by UK residents, as compared with UK assets held by foreigners. As Nickell noted, "since 1990, the net portfolio of the United Kingdom has been strongly positive in equity type investments... and strongly negative in debt type instruments". And in a footnote, he added the comment that this meant that the UK's position was "not dissimilar to a large bank".

Since equity-type investments tend to give a higher yield than the interest on debt, the UK has, for most of the recent past, earned a surplus on the income element of its current account. Chart 8 shows the surplus on the income element of the UK current account since 1996, as a percent of GDP. Also shown on the chart is the net deficit on trade in goods and services, less oil.

Chart 8: UK net surplus/deficit on current income and on goods and services less Oil (% GDP)



As can be seen, the growth in the income element in the early 2000s largely, but not completely, countered the marked deficit at that time in trade on goods and services.

Overall, what has been seen in this chapter is how the fluctuations, and overall decline, in the UK's level of general competitiveness have been associated with corresponding fluctuations, and an overall marked worsening, in the UK's deficit in trade in goods and services other than oil. In the early 1980's, this worsening trade situation was financed largely by oil revenues. From the mid 1980's, however, the UK has relied increasingly on the financial sector. In the process, the UK economy has been turned into something which has been likened to a very large bank, which, by 2011, had assets (that is, foreign assets owned by UK residents) and liabilities, (that is, UK assets owned by foreign residents) both of a magnitude equivalent to over seven times the UK's GDP: and with net annual additions to these assets and liabilities commonly of a magnitude equivalent to over 50 per cent of GDP.

Section Three: Implications at the UK level.

So far, the analysis in this paper has been purely factual: there has been no attempt to draw out the implications of the situation that has been described, or to assess whether the current UK economic model is sustainable. The final two sections of this paper now consider these types of question. This section deals with the UK level, and the next section looks at implications for Scotland.

This section addresses three main questions. First, how well has the UK economy been managed: second, does the UK constitute an optimal currency area: and third, how sustainable is the structure of the UK economy which has emerged over the past sixty years?

How well has the UK economy been managed?

As was seen in Section One, one feature of the UK economy since 1972 is the extent to which it has experienced relatively large medium term fluctuations in competitiveness. This suggests either that the UK economy is peculiarly subject to external shocks, or has been badly managed, or both.

An economy like the UK's, which is open, and highly dependent on trade, will indeed be vulnerable to external shocks. There is also, however, strong evidence that the economy has been badly managed. For example, the fact that, for three significant periods of time (the late 1970s, the late 1980s, and from about 2002 to 2008), the exchange rate was allowed to appreciate, even though internal price levels were rising significantly, suggests that there was insufficient appreciation by policy makers of the potential dangers which the resulting loss of competitiveness would pose for the manufacturing base of the economy. It seems quite likely that misguided pride in having an apparently strong currency may well have got in the way of a proper appreciation of the damage that was potentially being done to the wider economy.

There also seems to have been a general view that the UK was moving into a post-industrial phase, and now had a 'service based' economy. Policy makers seem to have missed the point that the underlying balance of trade in goods and services, which had been flattered for a time by oil revenues, was deteriorating rapidly: and that the deficit was being covered by borrowing, and by current income, both largely dependent on the financial sector. Nor did policy makers appear to appreciate what risks the financial sector might pose to the economy, and how unstable the tax revenues derived from the financial sector might be.

Overall, there was a lack of any coherent economic strategy designed to make sure that a successful wider economy was developed, whether based on manufacturing or a broad range of services, which could compete in world markets. In fact, in several respects (for example, in relation to monetary policy, or in relation to negotiations with the EU) decisions were taken with the primary focus of benefiting or protecting the financial sector, but which were not in the interests of the wider economy.

These indications of significant failings in the management of the UK economy are drawn from the specific areas considered in this paper. Looking more widely, there are also other clear indications. For example, consider the size of the public sector deficit: that is, the extent to which the expenditure of the public sector exceeds its revenues in any year – essentially, the public sector deficit is the amount which the public sector has to borrow in that year. Any economy which had, as the UK economy did in 2009, a public sector deficit equivalent to over 11 per cent of GDP can hardly be called well managed.

Overall, the evidence points to clear evidence of long standing and consistent mismanagement of the UK economy.

Has the UK constituted an optimal currency area?

The theory of optimal currency areas states that participant regions should have similar business cycles, and that conditions should be sufficiently similar between the different areas so that the same monetary (and hence exchange rate) policy will be ideal for all the constituents at once. In the UK, however, conditions which have been favourable for the financial sector (and, indeed, were designed to be favourable for that sector) have been very sub-optimal for much of the general economy. This is reflected in the widely differing economic performance of the UK across different regions – with a marked imbalance emerging between the financially dominant South East, and declining former industrial areas. Whether or not one buys in to the theory of optimal currency areas, it is quite clear that the postulated conditions do not hold for the different sectors, and geographic areas, of the UK.

How sustainable is the UK economic model?

As described in the earlier sections of this paper, the general competitiveness of the UK economy has been declining, and two main sources have been used to fund the resulting deficit on current account. First of all, oil revenues: and secondly, the borrowing and financial flows associated with the City.

It was not a sustainable strategy to use a finite and irreplaceable resource, like oil, to fund current consumption. But since oil revenues have, in any event, declined in relative importance, the key question for the UK now relates to the sustainability of its position as regards the financial sector.

As has been seen, the UK is, effectively, operating like a very large bank: with international assets and liabilities which are very large in relation to the size of the economy, at over 700 per cent of GDP.

There are, traditionally, three main risks which a bank is exposed to: namely,

- *Credit risk: that is the bank makes bad investments.
- Liquidity risk: the bank's funding runs out.
- Interest risk: the bank earns an insufficient return on its investments to pay for its funding costs. *

Viewed as a large bank, the UK economy is clearly potentially subject to exactly these kinds of risk. For example, in 2011, one third of the assets of "Bank UK" were in the form of various types of financial derivatives (the aggregate value of which amounted to 240 per cent of UK GDP). But this is an asset class which had proved so toxic as recently as 2008: so even on the financial derivative score alone, "Bank UK" must be substantially exposed to credit risk.

Or take liquidity risk: the analogue of liquidity risk for "Bank UK" would be if international investors took fright, and were no longer willing to invest in, or extend credit to, the UK. Sterling crises have happened in the past, and could happen again. So the potential of liquidity risk for "Bank UK" has to be regarded as a real possibility, rather than a purely theoretical risk – particularly in the light of the recent downgrade of the UK's credit rating.

As the events of 2008 showed, if the financial sector hits a crisis, then in the last resort the Government has to step in, and use the resources of the state to underpin the stability of financial institutions. So in a basic sense, the fundamental resource which underpins the stability of "Bank UK" is the underlying economy, and its tax raising capacity. But here there is a paradox: the UK general economy has in itself been weakened by its reliance on the financial and oil sectors – and by the fluctuating and generally overvalued exchange rate which this has caused. If the general economy has been weakened by using the financial sector as a prop, then the general economy is likely to be too weak to be used as an effective support, if and when the financial sector hits trouble.

This can be clearly seen in the events of 2008: the UK economy is still struggling to cope with the increased public sector debt levels, and reduced tax revenues, which resulted from that crisis. Public sector net debt, which as late as March 2008 had been 36 per cent of GDP, had increased to 58 per cent of GDP by 2010, in the immediate aftermath of the crisis. In 2013, it is estimated that it will be 75.9 per cent: and, according to what are generally felt to be the fairly optimistic forecasts produced by the Office for Budget Responsibility (OBR, 2013) public sector net debt is projected to be over 85 per cent of UK GDP before it starts to fall as from 2017.

It might be argued that the problem which the UK faced in 2008 was that individual financial institutions were too big to fail: and that the UK could avoid a repetition of 2008 by ensuring that no individual financial institution becomes too large. Individual institutions could then be allowed to fail, without there being a burden on the public finances. This argument, however, is fallacious, because the failures of individual financial institutions are not independent events. A future financial crisis is likely to arise either through the writing down of a whole class of assets, or through overall flight by investors. Either of these events could put at risk a large part of the UK financial sector, and would require state intervention: even if each of the individual institutions at primary risk of failure was in itself fairly small.

The financial crisis of 2008 occurred at a time when the international assets and liabilities of "Bank UK" were at a level equivalent to 760 per cent of UK GDP. After falling back somewhat, these assets and liabilities are increasing rapidly again, and are back at over 700 per cent of GDP. So if the UK was under-capitalised, in terms of the strength of the general economy, to deal with the 2008 crisis (and is still struggling to deal with the resulting debt) it must be even more under-capitalised now to deal with any future shock (or with any further round of the 2008 crisis). The conclusion appears unavoidable: the present model of the UK economy is at serious risk of not being able to cope with any further serious shock to the financial sector. And since (in the present unstable state of the world economy) such shocks are almost inevitable, the current model of the UK economy is unlikely to be sustainable.

This pessimistic conclusion is reinforced when the dynamics of the present UK financial model are also taken into account. From 1992 to 2011, the assets and liabilities of "Bank UK" (relative to GDP) grew at the astounding rate of around eight per cent per annum, compound. At this rate of growth, the assets and liabilities of "Bank UK" double every nine years relative to GDP. This rate of growth cannot continue indefinitely: for one thing, there are just not enough sound assets to invest in. And yet, in a sense, high levels of growth in the assets and liabilities of "Bank UK" are an intrinsic part of the system. A significant part of the income generated by the City comes from the fees and commission associated with mergers and acquisitions, and the development of new credit instruments. The UK economy would find it very difficult to cope without the returns generated by this kind of activity: but, on the other hand, this very activity puts the assets and liabilities of "Bank UK" on a growth trajectory which is unsustainable. It is as if the UK were riding on a wobbly bicycle, and having to peddle faster and faster to stay up: but with the increased speed only making the final crash more inevitable, and more severe.

Overall, the conclusion appears inescapable that the present model of the UK economy is inherently unstable, and is at severe risk of imposing further substantial burdens on the long suffering UK taxpayer, and quite possibly of collapsing altogether. Had taxpayers been aware of how the economy was being developed, and had there been proper democratic accountability in the UK, it is extremely unlikely that the taxpayer would have signed up to underwriting this model.

Section Four: Implications for Scotland.

Finally, this section considers the implications for Scotland, in relation to the independence referendum scheduled for 2014.

One of the most striking features of the referendum debate so far is the way it has been conducted under the implicit assumption of the continued strength and stability of the UK economy. It is not just that the unionist side in the debate has pointed to dangers, uncertainties and possible poverty which an independent Scotland would face, and has contrasted this with the stability and prosperity supposedly on offer under continued membership of the UK: this is an entirely predictable tactic. What is surprising is the extent to which important elements on the nationalist

side stress, not the weakness, but the presumed strengths of the wider UK economy: and have devised an independence strategy which is designed to exploit these presumed strengths. Thus, the position advocated by the SNP-led Scottish Government is that the UK currently approximates to an optimal currency area, (Scottish Government, 2013): and the SNP recommends that an "independent" Scotland should continue to be a member of the UK currency union, retaining the Bank of England as central bank.

It is not the intention of this paper to go into whether or not it would indeed be possible to combine any meaningful form of independence with continued long term membership of a UK currency union – even assuming that currency union was strong, stable, and optimal. (It is, however, the view of the author that meaningful independence is not attainable within the UK monetary union.) The important point for present purposes is that the evidence analysed in this paper suggests that the present UK economic model has profound, and growing, problems. In addition, the current UK political leadership (of all parties) appear utterly paralysed in the face of impending catastrophe: and have no credible strategy for rebasing the UK economy.

In the light of this analysis, nationalist strategy on the 2014 referendum needs to be rethought, and current tactics reversed. Tactically, far from implicitly accepting as a given the continued strength of the UK economy, what should be stressed is how much the wider economy, both in Scotland and the UK, has suffered under the current economic model of the UK: and, in addition, the very real future dangers arising from the unsustainable nature of the UK economic model should be emphasised. The UK will always remain a primary trading partner for Scotland: so UK economic instability will always affect Scotland. But what nationalists should be pointing out is how independence could potentially insulate Scotland from the worst effects.

Strategically, since the UK is clearly not an optimal currency area, the nationalists should be developing an approach which points out the benefits of Scotland ultimately having its own currency. One main argument put forward against this position is that a relatively small country, particularly one with substantial oil resources, would find it very difficult to manage its own currency without damaging instability in its exchange rate. In fact, the evidence presented in this paper suggests that this is far from being the case. Small countries can have unstable exchange rates – as can large countries. But among advanced economies, over the period analysed small countries like Norway, Denmark and Switzerland have had real exchange rates which have been much more stable than the UK's.

The analysis presented here, however, has implications which go far beyond the actual vote in the 2014 referendum – but which extend to the status of the referendum itself. Imagine that there was a 'No' vote on Scottish independence in 2014. Imagine also that, a few years later, the UK experienced a profound economic crisis. It is quite unclear what would emerge from such a crisis, either in terms of economic structure, or in terms of the nature of the political regime at Westminster. But at that point, it would be perfectly proper for Scotland to ask itself if it wanted to continue in the direction in which the UK was travelling – or whether it wanted to reconsider independence. However, such a move would be blocked, in the light of the final clause of the Edinburgh Accord signed between Alex Salmond and David Cameron, which binds both parties to respect the referendum result as final.

What this points to is the nonsensical nature of the final clause of the accord. There is a strong case for arguing that Alex Salmond should never have agreed to this aspect. After all, Scotland's right of self determination is inalienable, and not something which he can sign away. But the accord which Alex Salmond has agreed to has the precise effect of signing away this right, for an unspecified, but inevitably lengthy, period after any 'No' vote in 2014. Equally, David Cameron himself is not actually in a position to honour his side of the accord: implicit in the Cameron side of the accord is the assumption that, if Scotland voted 'No' it would remain part of a UK which

would continue indefinitely as a stable and prosperous state. But as the analysis in this paper indicates, the continued stability and prosperity of the UK is not actually within Cameron's power to deliver.

Interestingly, David Cameron has also breached his side of the accord in another respect – in relation to EU membership. Subsequent to signing the Edinburgh accord, Cameron announced that there would be a referendum on the UK's continued membership of the EU – and this will take place after the Scottish referendum. Scotland cannot be expected to take a final decision on its constitutional position in relation to the rest of the UK, without knowing whether, a year or two later, the UK might decide to leave the EU.

It needs to be stated now, very clearly, that the final clause of the Edinburgh Accord is a dead letter, and that nothing can take away the right of the Scottish people to decide their own future – a right they are likely to need in the event of the looming crisis in the UK economy.

References

Nickell, S., (2006): "The UK current account deficit and all that": Bank of England Quarterly Bulletin, Summer 2006.

ONS, 2012: "United Kingdom Balance of Payments: The Pink Book".

OBR, 2013: "Economic and Fiscal Outlook, March 2013".

PWT 7.1: Alan Heston, Robert Summers and Bettina Aten, "Penn World Table Version 7.1", Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania, Nov 2012.

Scottish Government, 2013: "Fiscal Commission Working Group – First Report – Macroeconomic Framework".

Annex: The Real Exchange Rate.

1. Let A and B be two countries.

Suppose that the exchange rate between the currencies of country A and country B is $x(A,B)$, (expressed as a ratio of units of currency A to currency B).

Let $p(A,B)$ be a measure of purchasing power parity between country A and country B: this is a measure of the relative price levels between country A and country B, and can be thought of, loosely, as the cost of purchasing a standard basket of goods in country A, relative to the cost of purchasing the same basket in country B, (and is also expressed in units of currency A relative to currency B).

Then the real exchange rate of country A relative to country B, denoted $r(A,B)$, is defined as

$$r(A,B) = x(A,B)/p(A,B).$$

If the cost of a "standard basket" of goods in B is Y, (in the currency units of country B), then this corresponds to $x(A,B)*Y$ units of the currency of country A, when converted at the exchange rate.

But the cost of a standard basket of goods in country A is $p(A,B)*Y$ units of the currency of A.

So the number of standard baskets that can be bought in A, for the cost of one standard basket in B, is

$$(x(A,B)*Y)/ (p(A,B)*Y) = x(A,B)/ p(A,B) = r(A,B)$$

In other words, the real exchange rate can be notionally thought of as the number of standard baskets of goods in country A which can be bought for the price of one standard basket in B.

2. The Penn World Tables, version 7.1, (which is the source of the data analysed in Section 1 of this paper), expresses exchange rates and purchasing power parities relative to the United States as base. To find the real exchange rate between any pair of countries, it is therefore necessary to take the ratio of the real exchange rates, (relative to the US), of the relevant countries.

When compiling real exchange rates for a group of countries, the approach adopted here was to calculate a weighted geometric average of the individual country real exchange rates, with weights proportional to each country's GDP. Use of the geometric average means that the real exchange rate can then be decomposed into multiplicative exchange rate and purchasing power components, as given in Chart 3.



Web: www.reidfoundation.org

Phone: 0845 557 6844

Email: contact@reidfoundation.org

The Reid Foundation
PO Box 8781
Biggar
ML12 9AG