33

File (have kept the original papers)

CHANCELLOR

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir A Rawlinson
Sir K Couzens
Mr Barratt
Mr Byatt
Mr Bailey
Mr Hancock
Mr Littler
~~Mr~~ Middleton
Mr Britton
Mr Unwin
Mr Lavelle
Mrs Lomax
Mr Neuburger
Mr Peretz
Mr Norgrove
Mr Spencer
Mr Ridley
Mr Cropper
Mr Cardona

COMPETITIVENESS AND THE EXCHANGE RATE

In my minute of 9 December I undertook to set down on paper my reservatio about the thesis contained in the paper by a Treasury working group circulated under cover of Sir Douglas Wass's minute of 1 December. I had hoped to do this during the Christmas recess: I apologise for having delayed it until now.

2. Let me say at the outset that I readily acknowledge the tremendous amount of work that has been done by officials on this exercise, not least the statistical analysis which I am in no position to challenge. To the extent that I disagree with the paper - and it is a pretty fundamental disagreement in places - my concern relates to those points where it crosses the boundary between analysis and polemic, and to a great deal of the thinking which is everywhere implicit in the paper - although not so often explicit.

3. The very term 'competitiveness' is unfortunate, since (in ordinary English) it would seem self-evident that an increase in competitiveness

1088/2

34

is a good thing, and a decline a bad thing. Linguistically, in other words, the paper contains - throughout - an implicit value-judgment which begs most of the key questions. For in the technical, economists', sense used in this paper (competitiveness = relative unit labour costs, an amalgam of wage rates, productivity and exchange rates) it is very far from self-evident that the more 'competitiveness' the better. Thus, for example, from charts I & II it can be seen that, over the decade 1967-77, UK competitiveness steadily improved, by some 25% overall, while German competitiveness steadily deteriorated, by some 30% overall. Yet few would surely contend that, during those 10 years, the performance of British industry dramatically outpaced that of German industry in any sense whatever - not even as measured by relative shares of world trade. In fact, of course, the reverse was the case; and the so-called decline of German competitiveness over this sustained period was a sign of strength, just as the sustained improvement in UK competitiveness was a sign of weakness. None of this means that the concept of competitiveness as used by economists (and in this paper) is wholly valueless: simply that it doesn't mean or imply what ordinary people might think it means or implies. There is, perhaps no obvious alternative term to this concept, but one only has to substitute something like 'export cheapness' to see the importance of this linguistic dimension.

4. It is worth spending a moment longer on the UK/German comparison mentioned above. 'Competitiveness', as has been pointed out, is an amalgam of domestic (unit labour costs) and external (the exchange rate) phenomena, <u>with the two components given precisely equal weight and treated with total indifference</u>. Thus over the period in question, Germany was a low wage settlement, low inflation, high productivity growth economy, whose exchange rate (no doubt partly because of market expectations) consistently ran ahead of the relative improvement in domestic unit labour costs, thus producing the secular decline in so-called comptitivenes while the UK was the exact opposite: a high wage-settlement, high inflation, low productivity growth economy whose exchange rate (again doubtless partly because of market expectations declined faster than the worsening of relative domestic unit labour costs

35

thus producing the secular improvement in so-called competitiveness. Who can seriously doubt that, in real life, the better German domestic performance - both in terms of inflation, which affects the level of wage settlements, and in terms of the 'real'yardstick of productivity growth - is in no meaningful sense cancelled out by the (in the circumstances, only to be expected) appreciation of the exchange rate. After all, if the exchange rate overshoots, there can always be a correction - as is arguably occurring with the Deutschemark now. But the real gains secured by anenvironment of low inflation and high productivity growth remain. These are the factors that really matter, and which relate to competitiveness as it is (rightly) understood in plain man's English.

5. Or take a different, and this time hypothetical, example. Assume two countries, each with precisely static 'competitiveness' in the economists' sense. But one has achieved this via stable prices (and wages), high productivity growth and a rising exchange rate , whereas the other has achieved it via rapid inflation (and wage explosion), declining productivity, and a falling exchange rate. Is it seriously suggested that there is nothing to choose between them? The truth of the matter is that the fact that the various components of competitiveness (so-called) are given precisely equal weight and treated with total indifference begs most if not all of the economically significant questions.

6. Does 'competitiveness' matter, then? The paper argues that it does, on the ground that, despite the UK/German experience mentioned above, the evidence shows that, for the UK taken on its own, changes in competitiveness have in the past had a significant effect on trade in general and on exports in particular. But this needs to be examined further. Of course in a crude sense, we need to export to pay for the very high proportion of our food, and for certain raw materials, we are unable to produce for ourseleves. But the proportion of our total import bill represented by food and raw material imports is very low (under 20%). Over and above that, trade is all about importing and exporting manufactured products. And it is misleading to

36

refer to any specific "need" to export, as if this could be precisely identified. Export markets are not the only markets open to British industry: there is always the home market, much of which is to a greater or lesser degree immune from foreign competition. No: the worry in the past has always been the effect of poor export performance on the exchange rate, and through the exchange rate on both inflation and, more fundamentally, living standards. In other words, competitivene: matters because exports matter, exports matter because the exchange rate matters, and the exchange rate matters because a falling exchange rate represents a real loss of national wealth. Yet the latter-day lamenters of our declining competitiveness actually advocate as its cure a lower exchange rate - the very evil those traditionally concerned with competitiveness have understandably sought to avoid. It is a bizarre volte-face. The innocent might be pardoned for thinking that if a lack of competitiveness leads - via a poor trade performance - to a lower exchange rate there is no need for artifical measures to achieve this all-too-familiar end; whereas if it does not, there is equally little point in seeking to induce it.

7. To give the paper its due, the alarm bells it sets off are wired less to general considerations of the kind mentioned above than to the specific circumstances of the UK since 1976. Much is of course made of the fact that our loss of competitiveness has been sharper than that of other countries, such as Germany - and this is rightly attributed at least in part to the emergence of North Sea oil and gas. It could, then, be claimed that, notwithstanding the general arguments stated above, the additional effects on competitiveness of North Sea oil deserve closer study. But I am not sure the outcome of such study is ever going to be that rewarding. There could never have been any doubt that the dramatic emergence in the late 1970s of this new sector of our economy - a sector for whose product prices are constantly tending to move ahead of the general price level and which sharply reduces our need to import at a given level of domestic costs - would make us less

37

"competitive" in the sense used in the paper. And, to the extent that the growth of the North Sea sector was unprecedented so too was our loss of competitiveness. Moreover, the post-1976 emergence of North Sea oil happened to coincide with the almost inevitable rebound from the exchange rate collapse of 1976, an ephemeral phenomenon to which British industry never had time to adjust and which must therefore be disregarded in assessing the adjustment problems in the other direction to-day. Thus the first sentence of the paper, which appears as a refrain later on, tells us far less than it purports to do. In short, the fundamental question "does competitiveness matter?" has not been answered.

8. There is also the fact that, despite a massive decline in competitiveness since 1976, British trade - including exports - is doing pretty well, in marked contrast to the official Treasury forecasts and the latest figures serve only to underline this. The paper uneasily seeks to explain this away, drawing comfort from the most recent trend in export <u>volume.</u> But since, in simple terms, exports are required to <u>pay</u> for imports, it is value not volume that matters. The concentration on volume in UK trade statistics is if anything rather more misleading than the similar concentration on the public expenditure front, from which we are rightly seeking to escape.

9. I mentioned above that 'competitiveness' is an amalgam of wage rates, productivity and the exchange rate and that all have equal weight. Yet, to repeat, everyone knows that in the real world an improvement in competitiveness due to a rise in productivity is infinitely to be preferred to a statistically equivalent rise in competitiveness produced by a fall in the exchange rate. In other words, the three factors need to be disentangled. And at the present time there is considerable evidence that the 'real' factor, productivity, is - in an underlying sense - behaving very satisfactorily, and with it unit labour costs as a whole. None of this, of course, is denied in the paper. But in practice it concentrates heavily on the exchange rate and gives least attention of all to productivity. There is the important statement in para 21 that "if our productivity stated to improve towards that in the US or Germany there would be substantial scope for improvements in labour cost competitiveness"; but this remark occurs in a section about "absolute" competitiveness",

which is dismissed as 'conceptually impossible', and the productivity dimension is virtually disregarded in the rest of the paper which is concerned solely with wage rates and exchange rates (notably the latter).

10. Finally, one or two thoughts about the policy implications. It is surely no accident that the paper does not go on to make any prescriptions, despite the starkness and inspissated gloom of the analysis. For the fundamential tenets of the paper are accepted, then two things follow. In the first place, such is the desperation of the message that any Government which accepted the fundamental logic of the paper would be forced to accept the need for urgent remedial action. And second, having accepted the need for such action, they would be led to the inexorable conclusion that the exchange rate should be brought down, and brought down substantially. No modest depreciation would do. As you know, I do not believe in that. I do not believe in that, because I consider an attempt to pursue an exchange rate target (which would require intervention on an unknowable but probably massive scale, whose consequences for monetary growth would be more certain than its effect on the exchange rate) entirely incompatible with a monetary target, and with the long-term reduction of inflatio No Western government has ever, for any length of time, managed to maintain exchange rate and monetary targets simulataneously, and few Western nations have been less well placed than us to risk such an adventure. For us to attempt this would lead, step-by-step, to the abandonment of our monetary objectives - an abandonment which would be as unnecessary as it was foolish.

11. I have a number of other, less central, reservations about the paper (including its interpretation of the 'thirties). But although I have not sought to set out a sustained counter-analysis of my own, I feel that the points set out above do shed doubt on the correctness of the fashionable thesis we are being asked to accept. Certainly, that thesis is scarely robust enough to justify any policy change. At the very least a more convincing answer is required to the basic question "Does competitiveness matter? And, if so, how much competitiveness do we need?"

NL.

NIGEL LAWSON
16 February 1981