A strategy for national economic renewal

A private discussion note (and not for general distribution) for the economic meeting on Monday 8th May

By Gerard Lyons

Introduction

Leaving the EU is a phenomenal opportunity but for it to be a success depends upon the policies we adopt and the path that we choose to take. Leaving is not enough.

Ambition is needed, in terms of where we want the economy to be. It goes hand in hand with outlining a vision to drive domestic thinking and how international investors and people overseas will see us. One approach would be for the UK to identify where it wants to be in a decade, and to then ask and determine what that means for policy now - including our EU exit strategy. We do not want to agree to things, such as adopting EU regulations in certain areas, that in a decade we will realise we didn't really need or want. This vision is important in order to ensure that businesses see beyond the near-term uncertainty associated with leaving the EU. Our thought process has been anchored in the EU for the last four decades and it will take time to change the way we think about ourselves. It involves identifying our strengths and playing to them, but also it is about having an economy that adapts and changes.

Humility is needed too. This is vitally important for anyone intervening in an economy. We need to have humility about what we can achieve over and above letting the market operate fully. If we are lucky, we can be very successful, but intervention in an economy can also have unintended consequences, and micro management should be avoided. Economies are impacted by so many factors - global, national, and local - it is not always possible to predict with precision how policies will work out, even if they were successful in the past. While the public sector has an important role to play, the approach should often be on creating an enabling environment to help people and the private sector do well, and the simpler things are, the better.

Near-term

I thought the post Referendum performance of the economy was predicable, resembling in some respects post Black Wednesday in 1992 and reflecting the competitive boost from a weaker currency and low rates, and the benefits of the global reflation currently occurring. But the next few years will be difficult, partly because we are late in the economic cycle, where after seven successive years of growth the economy is more likely to slow, real incomes are being squeezed and because the uncertainty associated with triggering Article 50 could impact investment. Indeed, most economists believe that there will be a permanent negative impact from Brexit via trade and investment. I disagree, but it is important to consider where the potential vulnerable points for the economy might be.

In this context, the scale of investment since last summer is particularly encouraging, as it suggests that many firms are looking through the near-term uncertainty and following through on previous commitments, or making fresh decisions, to invest in the UK. Google's commitment to London, for instance, has been cited by some in the City as particularly important, confirming London will remain at the leading edge of technology.

I do not want to focus here on the exit negotiations with the EU, suffice to say that **leaving the EU will not be a smooth process but leaving is undoubtedly in the best interests of the UK**. It is possible that there will be no deal, and we should already be preparing the groundwork for WTO rules. Even if a deal with the EU is worked out, as is the Govenment's aim, then an implementation period may be necessary, and could last a number of years. In addition to all this, the UK should be preparing at a faster pace or scale now for areas that will come back under its control, from extra patrol boats to police our fishing waters (we did order three extra patrol vessels in 2013/14 but more are probably needed) to increasing the technology spend at our ports. This year's autumn Budget needs to start making up for lost time.

Leaving the EU will lead to a return of competencies in a whole host of areas, from regional policy to state aid and we need to think through fully the opportunities this will provide. There will be the scope for future law making to diverge from Brussels, as we see fit. And, ironically, there are many things that we might have been able to have done anyway - such as building up overseas ties - that we will now have to do better.

Key issues

What are the key issues that need to be addressed by this group? When China addressed similar issues, a decade or so ago, they identified their five imbalances as: urban-rural, coastal-inland, social, environmental and international. I always liked this approach and perhaps we can learn from it as it mirrors, in different dimensions, some of the issues we face. What would be ours? Urban-rural would be one, London-other cities another, social yes, lack of mobility between income groups, owner occupiers-the rest, and in macro-terms an imbalanced economy. Although in terms of the latter, as previous Bank of England Governor Eddie George commented, imbalanced growth is better than no growth. There are many different definitions of imbalance, including the large current account and budget deficit and over-reliance on consumer spending.

I would suggest two issues stand out:

- The need to reward those who voted for Brexit, by recognising that parts of the present economic system are broken and need to change.

- We need to seize the opportunity of leaving the EU, and reposition the UK in a changing and growing global economy.

Let's take each in turn, while recognising the overlap that exits.

Brexit rewards

Above all, the UK needs to put **investing, innovation and infrastructure** at the centre of its economic thinking. The other "i" is **incentives**, as regardless of your political viewpoint, in economics one thing that usually works is incentives. We need a supply side reform that cuts taxes on income, and eases the burden on small and medium sized enterprises (SMEs). The issue of finance for SMEs and the role that banks can play is a perennial issue. Then there is making the industrial policy succeed.

What is wrong with the present system? It seems strange to be talking about a broken economic model given recent economic growth and high rates of employment. Data also shows, for instance, that the West Midlands is one of the highest recipients of inward investment in Western Europe. This highlights, if anything, that one size does not fit all, and policy needs to reflect this.

Wage growth has been relatively stagnant, and the broader picture is of the UK being a low wage, low investment and low productivity economy.

According to the Centre for Social Justice (CSJ), apart from the bottom decile in terms of income where there is change, the next three lowest deciles see little mobility. Once there, you stay. This led the CSJ to identify their five pathways (family breakdown, educational failure, worklessness, addiction, serious personal debt). We need to identify the economic factors that matter too.

Monetary policy: When it comes to monetary policy, let me share with you some work I am looking into. The first thing the Bank of England tells us on its website is that it is, "Promoting the good of the people of the UK by maintaining monetary and financial stability". But how is it promoting the good and who benefits? And what is the wider impact on society of monetary policy decisions and how do they impact the poorest in society. Has the maintenance of cheap credit allowed the poor to live beyond their means? Or have the poor used credit to enhance their standard of living beyond compressed wages and state welfare with an impact on skills, education, small business creation and cultural involvement? Has the national policy desire to keep house prices rising, reinforced by ultra-low interest rates, seen the poor priced out of owning, even in relatively cheap areas? Or has the buoyant house price market and external demand led to affordable construction in areas the poor would otherwise not have been able to buy into? Can they now no longer afford to buy a property or to move in search of work.

Above all, I feel that there has been a failure of macro-economic managment and long-term strategic economic thinking in the UK.

What, for instance, should the Treasury do differently? Austerity clearly did not work. Public spending does not appear under control. **What role should the public sector take?** Reducing the budget deficit is distinct from the size of the public sector. It requires a rethink about the role of the public sector, away from an obsession on its size, to a focus on what it does well. In many respects this has already begun, given the intense debate already underway about the NHS and social care.

We talk about upskilling the labour force but what should this actually mean in coming decades and how does this compare with the benefits from capital investment? Work and wages are impacted by many areas: unions, globalisation, financialisation and technology. What is the impact of each of these? How, for instance, are the oncoming changes in technology likely to change employment patterns and the need to work for the poorest in society? **How do we avoid unskilled workers doing only the dirty, dangerous and demeaning jobs**? As the nature of work changes, does the government need to start taking the idea of a state issued minimum income seriously?

Underpinning this is the need to **uphold workers' rights**. There is a fear among some that leaving the EU means a race to the bottom on workers' rights. There is no reason to believe that is what the country wants - and indeed, one point that is not always highlighted enough is that by returning sovereignty to Parliament we empower the UK public to truly get what they want in the future. We can compete globally on price or quality, but while we need to be competitive we wish to avoid a race to the bottom on price.

Regional policy: The tendency for young people to migrate to London is a concern, but perhaps understandable given the London Vibe. It is not uncommon for capital cities to dominate their economy, but less so among bigger countries. London accounts for one quarter of UK GDP. London's productivity outperforms the UK by 72%; it is not uncommon to see this picture in other countries too, given the tendency for capitals to attract clusters of high value added roles. Paris outperforms France by 67%; New York, while not the capital, outperforms the US by 36%. There is the need to allow London to compete internationally - and this includes attracting skilled labour - but at the same time there is a need to boost other cities and the regions. And where does fiscal devolution fit into this debate and should there be greater control by regional authorities over local infrastructure spending?

Housing: The debate often gives the impression that everyone needs to own a house that increases in value, which of course is nonsense. But incentives matter and people have been incentivised to believe that a sign of success is rising house prices, often negating the need to save. This needs to change, particularly as the amount of money people spend on housing or renting is a big problem. The incentive to get on the housing ladder needs to change. The focus should be on people having an affordable place to own or rent - preferably near their place of work.

Addressing the lack of housing supply includes many areas such as: new developments linked to transport expansion and brownfield sites, the need for more small developers, relaxing planning was a key driver in the 1930's and 60's and one question is whether it could work now, and the need to boost turnover in the secondary market and one way to help this may be to reduce stamp duty. Housing demand is linked to affordability and finance. There is also the need for a more efficient way to tax housing: there is widespread criticism of high stamp duty and other options include a land value tax. When it comes to prime London, while prices are already high, that reflects local supply and global demand.

Globally

The world economy is growing ($32 trillion at the turn of the century, $62 trillion when the financial crisis started, $78 trillion this year). How the world economy is divided is changing. More of growth looks set to come from the Indo-Pacific (this is from US through north-east Asia, China and south-east Asia through to India). This is the region of future demand. It reinforces the need for the UK to be focused on the future growth economies, and also to be mindful of where future innovation may come from too. The UK may need to think in terms of networks of like-minded countries, and even playing a leading role at the WTO, seeking for instance to reduce non-tariff barriers in services. Growth is also being divided in other ways. Inequality is rising, with low skilled and unskilled workers in the west losing out relatively. And often overlooked, more of global growth is explained by urbanisation and in particular by the growth of mid-tier cities across the emerging world. London competes globally, but do our other cities? How many mouths to feed impacts income per head. The UK needs a sensible migration policy in the face of changing global demographics. Finally, the quality of future growth matters too, with innovation vitally important. A new industrial revolution is already under way, with a host of areas, including artificial intelligence, robotics, green technology, stem cell research and financial technology. All of this should make us positive about future growth prospects globally. The UK needs to ensure it is positioned to benefit from this, and this feeds back into regional policy above, with clusters of activity, centred around existing areas of strength and universities, helped by better transport links, infrastructure and increased research and development. The UK - and not just London - needs to be seen globally as a good place to both conduct business "in" and "from".

The outlook for any economy depends upon the **fundamentals, policy and confidence**. Of all of these, confidence is the hardest to predict. We need to be mindful of the image that international investors are receiving of Brexit via certain sections of the media, not all of which has been considered, and which may have dented confidence. If that is so then the government needs to work hard to counter-act this. While the government is saying the right things, with a constructive message, perhaps even more is needed, to cheer-lead for Britain and boost confidence about our future prospects.

Gerard Lyons
Email: drgerardlyons@yahoo.com
3rd May, 2017