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Chapter Twenty-Six

Britain in the World Economy

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Introduction

During the second half of the twentieth century the international economy expanded in size and complexity. The integration of goods and capital markets culminated in the 1980s and 1990s, described as an era of 'globalization' comparable to the late nineteenth century. As this process unfolded, there was a steady reduction in Britain's prominence as a world economic power both in quantitative terms and in terms of influence in global policy-making. This had as much to do with the evolution of the international economy as with Britain's own economic strength. The rapid expansion in global trade and investment and the increase in the number of countries involved compared to the nineteenth century inevitably left the British economy in a less prominent position. This trend also reflected a more fundamental shift of economic strength and influence toward the US economy that had begun before the First World War and was enhanced by America's war experience.

The era began with Britain exercising its still considerable influence in global policy-making. Indeed, the entire framework of the post-war international economic system was born out of wartime relations between the United States and the UK. Through the post-war years, despite heavy domestic economic burdens, Britain managed an international currency that ranked second only to the US dollar and was the unit of account for half of the world's trade. As the 1950s progressed, however, the sterling area drew apart as the economic interests of its members diverged. Rapid recovery and then economic integration helped continental European countries to outperform the British economy. By the 1960s, Britain was busy trying to retract its international obligations and the global role of sterling was effectively ended by devaluation in 1967.

From the 1970s the entire framework of the international economy changed under the pressure of successive oil crises and the end of the fixed exchange rate system. The new floating exchange rate regime and general economic crisis of this decade prompted most countries to pause in the process of international economic integration that had begun during the long boom of the 1950s and 1960s, and to turn

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inward. Nevertheless, in this period of crisis Europe finally accepted British entry into the Common Market. This European focus then came to dominate the policy side of Britain's international economic relations for the next three decades, as Britain struggled to come to terms with the political, social and economic features of the continental European project. This culminated in Britain's decision not to join in the introduction of the euro at the beginning of 2002.

At the same time as Britain's global rank in the international economy declined, these contacts became quantitatively of greater importance to the British economy. In the first era of globalization at the end of the nineteenth century, when Britain's international economic power was at its height, international trade rose from 12 per cent of gross domestic product (GDP) in 1870 to 17.7 per cent by 1913. The share then gradually increased, and by 1992 merchandise exports had climbed to 21.4 per cent of GDP.[1] This was despite the fall in Britain's share of world trade from 25 per cent in 1950 to 5 per cent by 2000. Foreign investment also increased as a share of GDP from under 2 per cent in 1963 to 22 per cent by 1999. The importance of international financial activity placed the City of London as the world's most important banking centre in 1970, and it still held that position in 1990. The trend of British international economic relations in the later twentieth century is not, therefore, a story of linear decline or withdrawal but rather of adaptation to new circumstances. By 2000 the international economy, with its much greater trade in services and much larger and freer international financial markets, was a very different entity than the era of protectionism and controls of 1939, and Britain's place in that system had changed dramatically.

Setting up the Post-War World Economy

It was clear early on in the Second World War that the USA would emerge from the conflict strengthened both economically and strategically. The US, alone, however could not determine how the international economy should be designed. As the world economic leader since the nineteenth century, Britain was a key player in designing a new system that would avoid the pitfalls of the disastrous inter-war economic chaos that had contributed to the outbreak of conflict in Europe so soon after the close of the First World War. In return for aid through the lend-lease agreement of 1942, the USA insisted that the British government commit itself to helping to achieve America's goal of freer trade and payments once the war ended. Ironically, therefore, it was Britain's wartime weakness that launched them into such a prominent role in planning the organization of the post-war international economy.

A major feature shaping the outcome of these negotiations was the similarity of opinion in America and the UK about what the post-war system should be. Both agreed on the importance of a smoothly running system of international trade and payments as a prerequisite to a lasting peace, and also that widely fluctuating exchange rates such as those experienced in the 1920s and the 1930s generated instability and friction between countries. In order to allow governments to have the confidence to free up their trade and payments and yet retain stable exchange rates, some form of international credit was necessary to tide countries over short-term imbalances without resorting to competitive devaluation or controls. Essentially, the US and the UK hoped to create a fixed exchange rate system policed by an international institution that provided short-term lending as a cushion against short-term balance of payments problems. A new and deliberately managed payments system was the necessary foundation for this new world order, since trade could not be conducted on a multilateral basis unless every country's currency were convertible to allow trade deficits with one trading partner to be offset by surpluses with another. The first hurdle, therefore, was the design of a new international monetary system.

The British plan, by J. M. Keynes, offered a large pool of $26 billion-worth of credit through an international clearing union (ICU). The system would work along the lines of providing overdraft facilities to each member country. Those in surplus as well as those in deficit in the union would have incentives to return to balance. The ICU was much too large for the American public to support since, as the only major creditor country after the war, the US could be obliged to supply most of the credit. The American plan, by Harry White, was much smaller ($5 billion), and required each member to contribute cash to a collective fund. The onus of adjustment was solely on those countries in deficit. Both plans were published in April 1943, and in September, 30 countries met in Washington to conclude a joint statement of general principles. On the basis of this outline plan, 16 countries met again in Atlantic City in June 1944 before moving on to Bretton Woods, New Hampshire, where 730 delegates representing 44 members of the United and Associated Nations hammered out the terms of the International Monetary Fund and the International Bank for Reconstruction and Development.

The IMF closely followed the American plan for a contributory fund, although it was slightly larger, at $8.8 billion, of which the USA put in $2.75 billion, and the UK contributed $1.3 billion. Exchange rates could fluctuate 1 per cent on either side of a par value with the dollar. The fund was designed to provide members with a cushion of credit to give them the confidence to abandon exchange and trade controls while keeping their exchange rate stable in terms of US dollars. It did not, however, deal with how the transition from war through reconstruction to recovery was to be achieved. The IMF was specifically not to lend for relief or reconstruction arising from the war. Article XIV allowed members to keep exchange controls for three to five years, after which they had to report annually on why controls still remained. This left open the absolute deadline for abandoning exchange controls or trade restrictions, and in the event they were not abandoned for current account purposes until 1958. The UK only abandoned its final controls on capital flows in 1979.

The world economy was particularly challenged by the shortage of American currency with which to buy the machinery and other products necessary for recovery. The US provided a bilateral loan of $US4 billion to the UK in 1946 with the proviso that exchange controls on sterling be lifted in July 1947. This proved disastrous as all the other countries hoarded sterling in the months leading up to convertibility and promptly cashed it in for US dollars when the time arrived. The drain on the UK foreign exchange reserves forced exchange controls to be reimposed six weeks later.

The failure of the Bretton Woods institutions to deal with reconstruction and recovery meant that other institutions developed soon after the IMF opened its doors in March 1947. In June 1947 the USA launched its Marshall Aid package for Europe that aimed to encourage European political and economic integration in return for

$US5 billion in aid. In September 1949 all European currencies, including sterling, were devalued without prior reference to the IMF. In 1950 Britain and other European countries founded a regional clearing union of their own, called the European Payments Union, in order to allow trade to be settled multilaterally amongst themselves while discriminating against the USA. Finally, the continuation and extension of wartime exchange controls on sterling put Britain at the centre of a multilateral trade and payments system known as the sterling area. This system was to be at the core of Britain's role in the international economy until the late 1960s and will be discussed in a separate section below.

While the weaknesses of the IMF were soon exposed, the momentum for international planning on trade policy was lost. Anglo-American negotiation was again the forum to set up an international code of practice for trade that would be overseen by a new international trade agency. A major disagreement soon emerged, however, over the principle of non-discrimination in trade. The USA was adamant about the need for all trading partners to be treated equally in terms of trade barriers. In 1932, however, the UK had established a complex system of Imperial Preference that offered lower tariffs for imports from the empire. In turn British goods were favoured by easier access to empire and Commonwealth markets. By the end of the war, Britain was even more convinced of the need to maintain discrimination against American imports given the emerging dollar shortage. A draft for an International Trade Organization was never ratified by the US or UK governments. In the end all that could be agreed was the General Agreement on Tariffs and Trade (GATT) in 1947, which ensured no new preferences on trade and that all future reductions in tariffs should be applied equally to all trade partners (i.e. on a 'most favoured nation' basis). Despite its inauspicious beginnings, GATT became an important forum for the reduction in trade barriers for the next 50 years and was only replaced in 1995 by the World Trade Organization.

In summary, the organization of the international economy was a major topic of negotiation among the Allied powers during the war. In an attempt to prevent a re-emergence of the economic conflict of the 1920s and 1930s that had contributed to the war, British and American planners aimed to create a deliberately managed and co-operative international economic system. By 1950, however, this vision had eroded into regional solutions to persistent economic imbalances.

The Sterling Area and the Commonwealth

As was mentioned above, one of the responses to the global depression of the 1930s was that Britain put greater emphasis on promoting trade within the empire by creating a symbiotic relationship in which overseas territories would provide food and raw materials and the UK would export manufactures. During the war this idea continued to be important in planning for the post-war recovery. The government hoped to develop the resources of the empire through British foreign investment for the benefit of both the overseas territories and British producers and consumers. By the end of the war, the dollar shortage made imperial self-sufficiency even more desirable, and ambitious proposals for economic aid for the empire were developed to this end.[2] These were supported by the continuation of exchange controls on the conversion of sterling to other currencies.

During the war, members of the Commonwealth and colonies agreed to pool their foreign exchange reserves in London to be used by the empire as a whole. In effect this meant exchanging all foreign exchange earnings to sterling and holding sterling assets as reserves. Britain also accumulated enormous short-term debts to particular members of the empire, in particular India, as part of the war effort. This debt took the form of British government securities held by overseas governments, and became known as sterling balances. By the end of the war, Britain had accumulated £2.3 billion in sterling debt, of which India held £1.3 billion. By 1950, however, India, Pakistan and Ceylon together had run down many of their sterling assets while other countries accumulated more. By this time the sub-continent accounted for only about a third of total sterling balances.

The continuation of wartime exchange controls created the post-war sterling area, which included all the Commonwealth countries except for Canada and all the formal British dependencies, plus some other countries, including Ireland, Iraq, Kuwait, the Persian Gulf States, Burma and Iceland. Members agreed to keep fixed exchange rates with sterling, to hold the bulk of their foreign exchange reserves in sterling and to impose exchange control in common with Britain to protect against possible flight from sterling to other currencies (in particular the US dollar). In return they enjoyed freer trade with Britain and freer access to British investment than other countries. The independent members of the sterling area also held periodic meetings under the auspices of regular Commonwealth summits to co-ordinate trade policy and domestic macroeconomic policy in order to maintain fixed exchange rates and conserve US dollars. Since all the members of the area held their foreign exchange reserves in sterling, this meant that they sold or pooled all their US dollars and other currency earnings in London. The so-called central reserves were then available for members to settle balance of payments deficits. Since the UK usually ran a surplus with other members of the sterling area, who in turn usually ran a surplus with the rest of the world, this meant that Britain had access to the foreign currency earnings of the empire and the Commonwealth.

Until the mid-1950s at least, countries in the overseas sterling area were mainly producers of primary products and consumers of manufactures, while the British economy was more diversified. The advantages of this specialization were felt especially in the raw materials boom associated with the Korean War of 1950–2, when the massive surpluses of the overseas sterling area offset the substantial deficit run by the UK. The balance of payments of the sterling area as a whole was relatively stable as a result.

For the independent countries, the rationale for membership was that the bulk of their trade was with the UK so it made sense to avoid exchange risk by keeping their reserves in sterling. However, as the competitiveness of British products and the size of the British market waned compared to the booming continental European economies in the late 1950s and early 1960s this commercial rationale became more tenuous. A second rationale was preferred – access to the London capital market. Commonwealth countries had ambitious plans for accelerating their industrialization, which relied on foreign investment. A fixed exchange rate with sterling was also believed to improve the ‘credit rating’ of members in the eyes of private foreign investors. Finally, it is important to recognize that there were not many viable alternatives to the sterling area for these countries. This was a period during which

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fixed exchange rates were the norm and fluctuations were frowned upon by the IMF and by the international community. The only real alternative to pegging to sterling was to peg to the US dollar. In the 1950s, members did not have enough dollars to build up sufficient reserves to establish such a peg. By the mid-1960s the US dollar was not such an attractive currency to use as an anchor since the US ran persistent payments deficits that threatened the link of the US dollar to gold.

During the 1950s some members of the sterling area built up sizeable reserves in the form of sterling balances. These represented potential claims since they could be converted in London for the currency needed by the holder. Since the rationale of the sterling area was to conserve scarce foreign exchange, outstanding sterling balances well outweighed the value of the central reserves (sometimes by as much as four times). This 'overhang' was deemed to make the British external economic position very fragile. In fact, however, the sterling balances were the 'normal' foreign exchange reserves of these countries and were unlikely ever to be 'cashed in' all at once except in times of crisis when emergency measures could be taken to protect the central reserves, such as drawing on the UK's IMF quota. The geographical distribution of the holders of the sterling balances also contributed to their stability, since an increasing proportion was held by colonies over which the UK had greater control. Even as colonies became independent in the 1950s and 1960s, they did not seek to run down all their foreign exchange reserves or to remove themselves from the sterling area, because they benefited from the confidence and stability of the link with sterling. Two of the largest newly independent countries – Malaysia and Ghana – went so far as to continue to operate currency boards for that reason.

In December 1958 Britain allowed sterling to be convertible for current account transactions, but this privilege was restricted to residents outside the sterling area. British residents and residents of sterling area countries were still subject to strict exchange control. With the end of the extreme dollar shortage, the need for closely co-ordinated macroeconomic policies was not so urgent. Through the end of the 1950s and into the 1960s the independent members of the Commonwealth began to develop more ambitious industrialization policies in an effort to diversify their economies. As a result, the complementarity of members' economies, which had been instrumental in cushioning the system through the primary product booms and busts of the early post-war years, receded. The UK still strove for price stability, while the developing countries strove for expansion even at the expense of inflation in the short term. By this time a persistent imbalance had also arisen, with the overseas sterling area being consistent net creditors to the central reserves and the UK a consistent net drawer.

The major reserve role of sterling (and the sterling area itself) was essentially ended after the devaluation of sterling in November 1967. After this crisis in the system, members negotiated exchange guarantees for their existing reserves (Basle agreements) and began to diversify them to achieve greater security. This security proved elusive, however, in the speculative maelstrom of the collapse of the international monetary system by 1971.

The sterling area was an international monetary system that was in place for over 20 years and involved close to half of the world's trade. It was instrumental in restoring multilateral trade and payments among a large and widespread group of devel-

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oped and developing countries in the post-war period. The experience of Britain as the leader of its own monetary system was also important to the development of its subsequent policy. The sterling area was the last stage in the erosion of Britain's domination of international payments, a process that can be traced from the heyday of the gold standard, through the cruel volatility of the inter-war period, to the shattered hopes for a managed utopia in the post-war period. After 1971, London sustained its role as a global financial centre, but this was based not on the importance of its own currency but rather on the proliferation of eurodollar business.

London as an International Financial Centre

Once external currency convertibility was established at the end of 1958, the international financial system began an acceleration of scale and innovation that well outstripped the rapid growth of world trade. The City of London, as the financial centre of Britain and regional financial centre for Europe, was particularly well placed to take advantage of this boom. Although exchange controls remained in force on flows of international short-term capital denominated in sterling, foreign currency business was relatively unregulated. It was this freedom that was the basis of London's resurgence as an international banking and financial centre from the 1960s after the moribund years of the 1940s and 1950s. In 1970 London ranked first in the world in terms of head offices and host to branches, subsidiaries and representative offices of the world's major banks, but had fallen to third place by 1980 behind New York and Tokyo.[3] Nevertheless, foreign assets as a share of total assets of banks in the UK leapt from 46 per cent to 68 per cent between 1970 and 1981.[4]

The source of this dramatic recovery was that London became the centre for the most important new financial innovation of the era, the eurodollar market. As a result of limits on interest payable on deposits in the USA, the high domestic demand for bank credit in the UK, and the growing supply of US dollars outside the USA, banks in London began in 1957 to accept deposits in US dollars, creating what became known as eurodollars. These deposits could then be lent on, often through other banks, to final borrowers at advantageous interest rates. In 1963 the first eurobond was floated in London. This was the issue of a bond outside the USA but denominated in US dollars and, like the eurodollar market, its main location was the City of London. This quickly became a very popular way for governments and large state and private companies to borrow. Eurodollar deposits were outside the jurisdiction of government regulators and so the market grew quickly (from $14.8 billion in 1968 to $70.8 billion in 1971, of which over half were held in the UK[5]) and attracted many banks to locate in London to take part. By 1960 American banks in London dominated the market, channelling some of the deposits back to their head offices in New York or using the market to service American corporations abroad. From 1965 to 1971, 69 foreign banks opened branches in London, of which almost 40 per cent were American banks. By 1970 there were 37 branches of US banks in London.

The eurodollar market was particularly important in helping to resolve the imbalances created by the oil crisis of 1973/4, which will be discussed below. In 1974, $23 billion, or 40 per cent of OPEC surpluses, were deposited in the eurodollar market, compared with $11 billion invested directly in the USA and $7 billion in the

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UK.[6] Many of these deposits were then lent on to developing oil-importing countries in Latin America and elsewhere. These were the seeds of the Latin American debt crisis that struck the global financial market in 1982.

Britain in the Golden Age

The era from 1955 to 1973 has been dubbed the golden age of capitalism, since it witnessed the rapid and sustained growth of developed countries. Britain did not enjoy as fast growth as Europe or the USA, but growth rates were historically high. Behind this enhancement in prosperity, however, the international economic system came under strain. The UK balance of payments suffered from chronic weakness, and repeated deficits strained the fixed exchange rate. The weak competitiveness of British exports undermined the current account, while the costs of overseas defence were a burden on the capital account. The series of balance of payments crises required repeated attempts to rein in inflationary pressure at home and negotiations for short-term credit from the USA and Europe to maintain the fixed exchange rate. The apparent prosperity at home made it difficult for governments to muster popular enthusiasm for the cuts in domestic credit and other contractionary policies that were increasingly demanded by Britain's creditors in Europe, the USA and the IMF to correct the external balance.

The UK's problems were part of the global payments imbalance that was characterized by persistent deficits in the USA and the UK matched by surpluses in Europe, particularly in West Germany. This was complicated by the expensive strategic expenditure of the UK and the USA in the Far East and Europe. As the USA became embroiled in an expensive and unpopular war in Vietnam in the late 1960s, the strategic and economic spheres of policy overlapped even further, while the strain on the US dollar had repercussions on confidence in the sterling exchange rate. Ultimately, Britain was forced to abandon the exchange rate and its strategic presence in the Far East from 1967.

The UK participated in various short-term measures to prop up the Bretton Woods system and was a main beneficiary of short-term credits from other central banks through the auspices of the Bank for International Settlements. There were also periodic increases in contributions to the IMF so that the total value of the fund rose from $9.2 billion in 1958 to $12.3 billion in 1970. The UK was also among the ten richest countries that pledged from 1962 to lend to the IMF in case of very large drawings through an arrangement called the General Agreements to Borrow (GAB). These countries became known as the Group of 10, or G10, and took over much of the planning for the future of the international monetary system in the 1960s. The GAB was first activated in response to a British drawing on the IMF in 1964 (in 1964–5 the UK borrowed almost £850 million). Over the next three decades, the finance ministers of the G10 continued to meet regularly to discuss international economic relations. A final area of co-operation was the gold pool set up in 1961 by leading central banks to co-ordinate intervention on the London gold market to support the US dollar.

While these short term measures ameliorated the international economic crisis, Britain hoped to resolve its difficulties in the longer term by increasing access to international credit through the IMF and worked hard to encourage the American admin-

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istration to do the same. European opposition, particularly from France, prolonged these discussions both within the IMF and among the G10. A series of conferences throughout the 1960s eventually delivered a plan for a special drawing right in 1967, but further argument over its implementation meant that it was not introduced until 1969. By this time, however, the solution was too little and too late.

Over the course of 1967, speculative pressure on the pound built up to the point where the exchange rate was no longer sustainable. After an expensive struggle with the market, on 18 November 1967 sterling was devalued from $2.80 to $2.40 per £1, but this did not resolve the underlying balance of payments problems as the global situation worsened. In March 1968 the gold pool collapsed after speculation spread to the gold price of the US dollar. Supporting the US dollar between September 1967 and March 1968 had cost the members of the gold pool $3.5 billion. The ensuing pressure on sterling forced Britain to borrow from the IMF in 1968. The prospects for the fixed exchange rate system were dealt a further blow by the revaluation of the Deutschmark and the devaluation of the French franc in 1969.

Finally, in August 1971, after sustaining persistent outflows of short-term capital, President Nixon announced the suspension of US dollar convertibility, cuts to the US aid budget and a surcharge on imports, effectively issuing an ultimatum to the international community to realign the international monetary system. The world's leaders scrambled to restore the system with the Smithsonian Agreement, which re-established new pegged exchange rates, but the pressure mounted again, and in February 1973 sterling was allowed to float free of the fixed rate. While most of the world's economies opted for floating exchange rates, the members of the EEC moved towards creating a zone of exchange rate stability among themselves. Britain, having joined the EEC in 1973, joined this system on 1 May of that year, but was unable to maintain stable exchange rates with its European partners in the volatile inflationary period, and was forced to re-float on 23 June. The end of the fixed exchange rate system ushered in a decade of international economic turmoil which will be discussed in a separate section below.

An Overview of Foreign Investment and Foreign Trade

The most striking feature of Britain in the international economy after the Second World War was the gradual decline in Britain's position relative to other countries in world trade. This was partly due to the faster growth of European countries in the 1950s and 1960s, and then the rise of other economies such as Japan and newly industrializing economies in Asia and elsewhere. The relative decline of Britain has generated a voluminous literature about the competitiveness of British production and manufacturing (see chapter 10).

Table 26.1 shows the decline in Britain's share in global manufacturing trade. This is not, however, a representative picture of overall trade since the share of manufactures in British exports declined in the 1980s with the rising importance of North Sea oil. By 1984, oil comprised 21 per cent of UK exports by value, compared with 4.5 per cent in 1973 when the first oil crisis struck. Figure 26.1 shows the impact of North Sea oil on the commodity distribution of Britain's exports. With the fall in the world price of oil, the share of oil exports had returned to their pre-oil crisis level by 1990.

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Table 26.1 UK share of world manufactured exports (%)

	Imports	*Exports*
1937		21.3
1950		25.5
1960		16.5
1970		10.8
1979		9.1
1990	5.3	6.2
1995	4.7	5.1
2000	4.4	5.1

Sources: 1937: S. Pollard, *The Development of the British Economy*, 4th edn (1992); 1950–79, N. F. R. Crafts and N. Woodward, *The British Economy since 1945* (Oxford, 1991), p. 12; 1990–2000: UNCTAD, *World Investment Report 2002*, trade in goods.

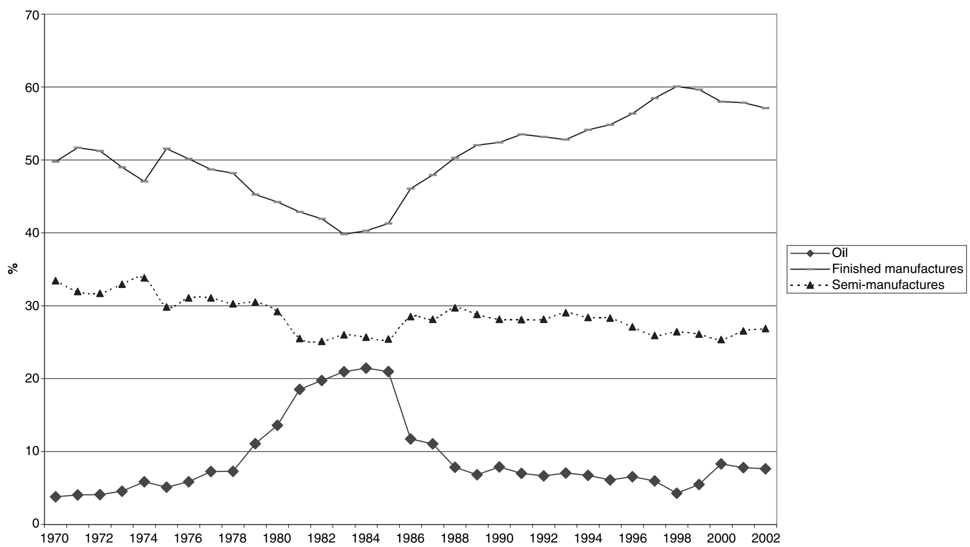

Figure 26.1 UK goods exports: share of selected categories, 1970–2002

Source: Office of National Statistics.

Another feature of British trade was the increasing role of services compared with merchandise exports. Although exports of services remained a fairly consistent 25 per cent of goods exports from 1955 to 2000, figure 26.2 shows that the large and growing deficit on the goods balance from the 1980s was partly offset by an increasing surplus in service exports. From the 1980s, exports of financial and other business services came to dominate this account, together comprising about one-third of services exports by 1991, and 45 per cent by 2000.

While Britain was of decreasing importance to world trade, exports of goods and services were an increasingly important share of national income. Figure 26.3 shows

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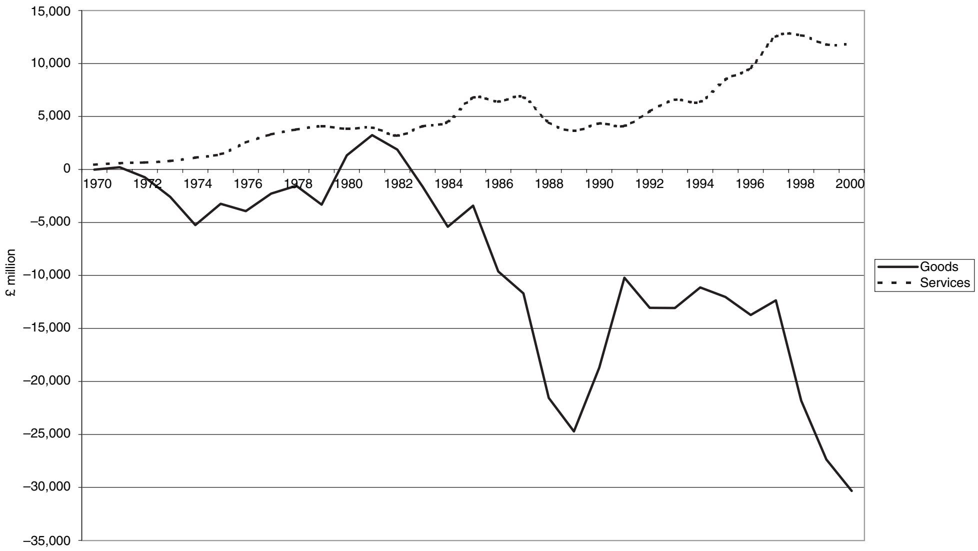

Figure 26.2 UK balance of trade in goods and services, 1970–2000

Source: Office of National Statistics.

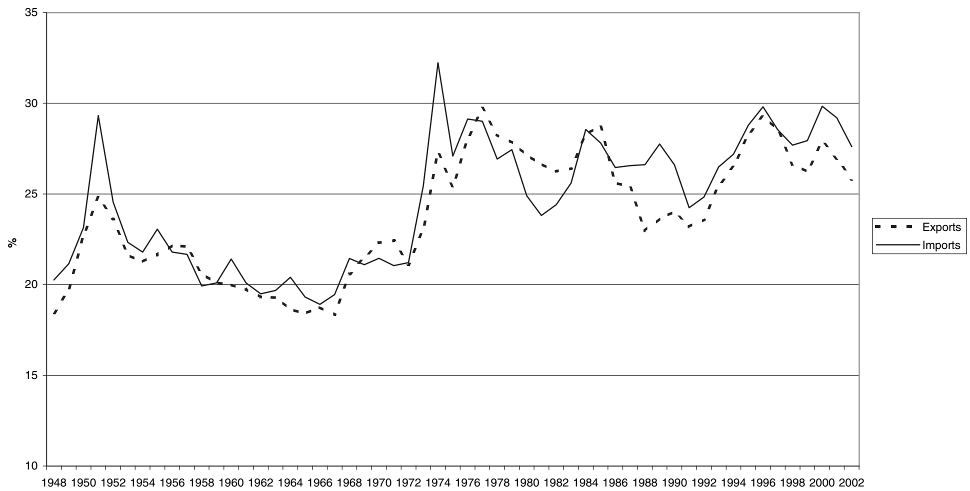

Figure 26.3 UK trade as % of GDP, 1948–2002

Source: Office of National Statistics.

that UK trade was consistently about 20 per cent of GDP in the 1950s and 1960s (except for the Korean War boom in the early 1950s).[7] The first oil crisis in 1973 marks a break in the trend, after which imports and exports of goods varied between 25 and 30 per cent of GDP. During the 1970s and 1980s the geographical pattern of Britain's trade also shifted, partly as a result of longer-term trends and partly as a result of European integration.[8] In 1973, when Britain finally joined the EEC, about one-quarter of British imports and exports were from/to the EEC, which was about the same percentage as trade with the overseas sterling area countries. By 2000 half of Britain's imports were coming from the EEC, and 57 per cent of British exports were destined for the EEC.

Another major feature of the development of the twentieth-century international economy was the spectacular increase in multinational corporate expansion. The UK was particularly well placed to take advantage of the foreign surge of US companies, especially from the 1950s. Sharing a common language and cultural heritage, American companies found Britain a sympathetic location from which to penetrate Commonwealth and European markets. Between 1950 and 1959 the value of US foreign direct investment (FDI) in Britain grew from $542 million to $1.6 billion. In this decade 230 new subsidiaries of foreign companies were opened in Britain, of which 187 were American.[9] In 1963 foreign companies accounted for about 10 per cent of net output of British manufacturing.[10] Foreign firms dominated British supplies of products, from computers and photographic equipment to breakfast cereals and razors. The stock of inward FDI amounted to about 6.5 per cent of GDP in 1960, rising to 27 per cent by the end of 1999. UK was the host for on average 8–9 per cent of the global stock of FDI for most of the post-1960 period, which is much greater than the UK's share of global GDP (about 3.2 per cent in 1998 on a purchasing power parity basis).[11]

During the 1970s FDI flows and trade flows grew at about the same rate, but from 1983 to 1989 flows of FDI grew three times faster than world exports. Most of this increase occurred from the mid-1980s with the emergence of Japan as a major overseas investor. In 1989 Japan overtook Britain's position as the largest source of outward FDI in the world (from 1980 to 1984 USA was number 1 and Britain number 2). Another factor prompting the increase in FDI was the global financial services expansion. New foreign bank branches came to London in the 1980s, restoring London to its position as the world's pre-eminent international banking centre in 1990. Also, British banks were involved in a spate of take-overs of US banks after the relaxation of American regulations in 1978. In 1979 alone, Standard Chartered, Natwest and Barclays spent $US1.2 billion acquiring US banks.[12]

For most of the post-war period flows of FDI rarely amounted to more than 2 per cent of GDP, but in 1999–2000 outward FDI leapt to almost 15 per cent of GDP. In these years there was a spate of mergers and acquisitions by UK firms of overseas companies. Some of the largest included telecommunications companies. The British firm Vodafone bought Airtouch in 1999 for £39 billion and then bought Mannesmann for £101 billion in 2000, making Vodafone the largest transnational corporation in the world.[13] Other major deals included BP and Amoco (£33 billion) in 1998 and Zeneca's purchase of Astra for £21 billion in 1999. Once this flurry of activity was over, however, FDI as a share of GDP returned to 2.5 per cent in 2002. The impact was to increase the stock of UK FDI but also to increase foreign holdings of UK equities, since many of these deals were financed through swaps of shares. This spate also restored Britain's share of the stock of world FDI. In 1980 this had been 15.4 per cent, but it fell gradually to 10.7 per cent by 1995. In 2000 Britain's share was back to 14.5 per cent of world stock of FDI.[14]

Figure 26.4 shows that, in addition to FDI, overall investment abroad increased considerably as a percentage of GDP over the post-war period. Much of the increase

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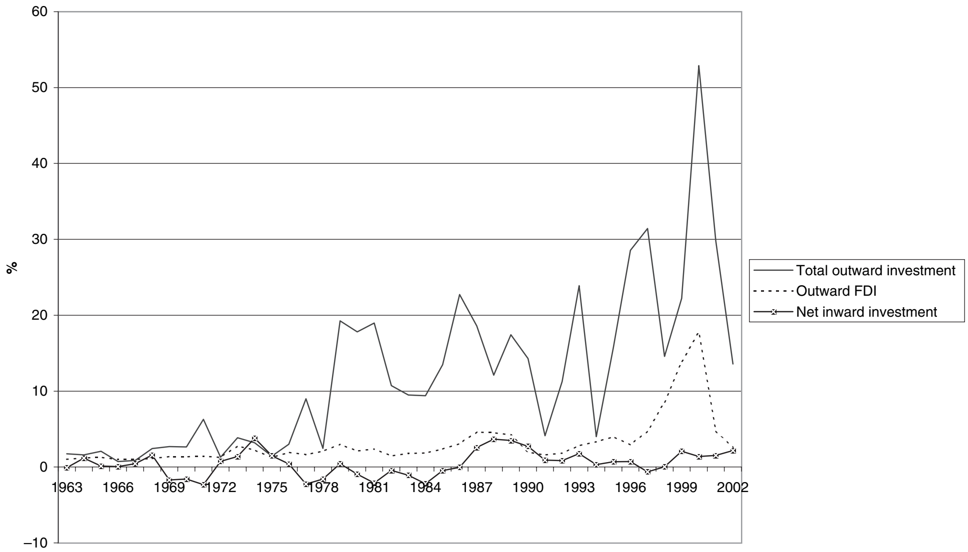

Figure 26.4 Foreign investment as % of GDP, UK, 1963–2002

Source: Office of National Statistics.

until the mid-1980s was investment in overseas equity and securities, which rose sharply after the end of exchange controls in 1979. From this time, overseas assets of British banks also increased dramatically as the City of London's activities expanded. The largest category of overseas assets and liabilities in the 1990s was bank deposits and loans, which grew quickly from 1987. At the end of 1999, deposits by non-residents in banks located in the UK amounted to just over £1 trillion. Of this, less than 20 per cent was denominated in sterling, the rest mainly in US dollars and euros. Also, 40 per cent of these liabilities were held in European banks operating in the City of London, while British-owned banks only accounted for 20 per cent of the total. The huge value of gross liabilities therefore reflected the activity of the international financial centre of the City of London and was substantially balanced by net assets of the banking system, so that at the end of 1999 net borrowing of the banking system was only £195 billion. The large proportion of inter-bank lending in the gross totals suggests there was only a weak direct link between these flows and the real British economy.

Figure 26.4 shows that foreign investment was more than matched by an inflow of investment into the UK, so that the net position was much more stable, hovering well below 3 per cent of GDP throughout the post-war period. This is considerably lower than the 5 per cent of GDP during the heyday of the gold standard in 1870–1914 (and over 9 per cent in the three years immediately prior to the First World War).[15] The United States overtook the UK as the world's largest holder of foreign assets after 1945. The UK share of world foreign assets was 50 per cent in 1914, but this had fallen to 21 per cent by 1960. In contrast, in 1960 the US share was 50 per cent in 1960. By 1995, however, with the dispersion of economic and

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financial activity, the US share fell to 22 per cent, only slightly above the share of the UK (16 per cent).[16]

In summary, the statistical evidence shows a mixed view of Britain's international economic relations. Britain has definitely benefited from the globalization of this era both in the form of attracting FDI and in hosting international financial activity. From the 1970s, international trade also became larger relative to the domestic economy. In contrast, however, the diversification of production around the world and the emergence of newly competitive manufacturing countries such as Japan and China resulted in a dramatic decline in Britain's share of world trade.

OPEC and the Turbulent 1970s

The overview of trade and investment has suggested that the international economy became a very different environment from the 1970s onwards. This era produced high inflation, low growth, unemployment, and fluctuating exchange rates. Financial innovation accelerated to cope with the new uncertainty and to finance the huge imbalance between oil exporters and oil importers. Figure 26.3 shows that, for Britain, this ushered in a new era when international trade was significantly larger relative to GDP.

The early 1970s were years of boom in the international economy. With the end of the fixed exchange rate system from March 1973, governments were freed from the balance-of-payments constraint on expansionary policies. This was reinforced by excess liquidity in the international economy as a result of the US deficits through the end of the 1960s and beginning of 1970s. This expansion generated increases in the world prices of food and raw materials. The price of foodstuffs increased 100 per cent from 1970 to 1974, and fertilizer prices increased 170 per cent. These commodity shocks set the stage for the OPEC oil crisis of 1973/4.

In October 1973 Western support for Israel in the Arab–Israeli war triggered an embargo on supplies of crude oil to industrial Western countries. The embargo was then replaced by price rises and cartelized supply arrangements under OPEC so that, from early 1973 to early 1974, the US dollar price of imported crude oil increased from \$3 per barrel to \$10. The impact was felt particularly acutely because international demand for oil is price inelastic: substitutes such as coal are expensive, and it is costly to switch from entrenched oil-burning technology. This meant that large increases in oil prices increased producer revenue rather than decreasing demand. The result was huge balance of trade deficits for most of the developed and developing world, and price rises for the wide range of products that used oil directly or indirectly as an input. Furthermore, as energy costs soared producers were forced to lay off workers in order to cut their costs. The result was slow growth, unemployment and inflation.

The UK, with its large coal reserves, was somewhat less dependent on oil than other European countries, but oil still amounted to almost 46 per cent of all energy use.[17] Moreover, coal supplies were disrupted by miners' strikes that necessitated a three-day working week. Net expenditure on oil imports grew by \$5.3 billion in 1974, contributing to an overall increase of \$6 billion in the current account deficit in 1974 compared to 1973.[18] Another impact of the oil price shock was that it fed through to the prices of almost all other products so that overall inflation accelerated. World inflation peaked at 15 per cent in 1974 but then receded to 13 per cent

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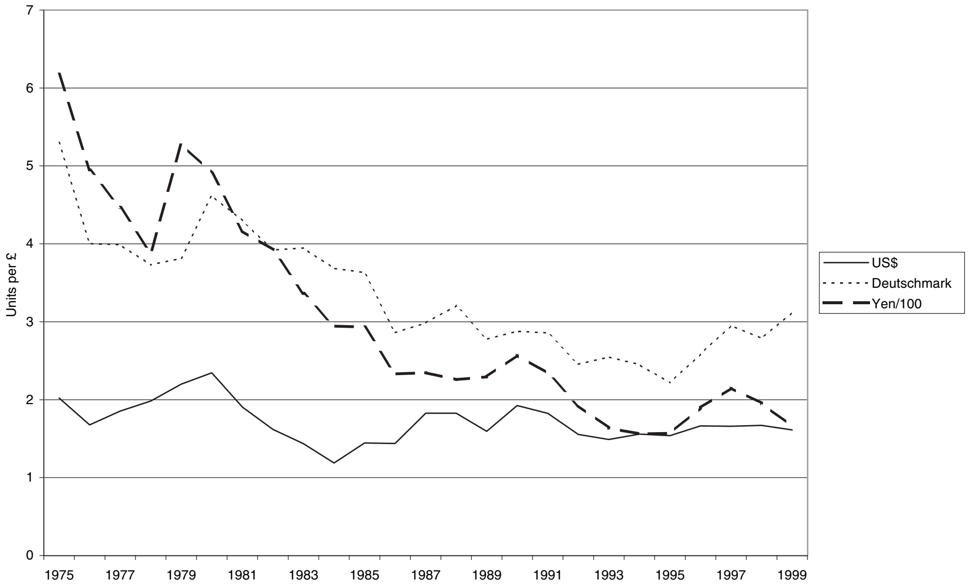

Figure 26.5 Nominal exchange rate of sterling, 1975–1999

Source: Office of National Statistics.

in 1975 and 11 per cent by 1977. In Britain, inflation hit 15 per cent in 1974 but then surged on to peak at 27 per cent in 1975 and stayed above 10 per cent a year for the rest of the decade as the impact of domestic expansionary policies combined with the commodity price shock.[19] The economic uncertainties of the 1970s sent speculative pressure once again against sterling, and Britain was again forced to borrow from the IMF at the end of 1976.

From 1974 to 1978 the real price of oil remained fairly constant relative to prices of manufactured exports, but another oil price shock began at the beginning of 1979 in response to the Iranian revolution. From this time until the first quarter of 1981, oil prices increased a further 170 per cent. As a result, the collective current account surplus of oil producers jumped from $3 billion in 1978 to $115 billion in 1980. The policy response by most governments was greater reliance on monetary contraction to contain inflation as the era of monetarism swept into the USA and the UK with the rise to power of Ronald Reagan and Margaret Thatcher. The oil price shock had particularly important implications for Britain since it increased the importance of North Sea oil and gas extraction, as seen in figure 26.1. The revenue from these exports through the 1980s eased the pressures that had plagued the balance of payments in the 1970s.

Figure 26.5 shows the movement in sterling exchange rates as of December of each year, showing a general depreciation except for a rise from the end of the 1970s due to the impact of North Sea oil. The exchange rate against the US dollar has been more stable than against the stronger currencies of West Germany and Japan in the 1980s (note that the yen rate is divided by 100 to allow comparability on the chart).

1980–2000

Inflation was successfully reduced in the 1980s, but this was at the cost of higher rates of unemployment. A sharp boom in 1988–9 was followed by a disastrous slump that pushed unemployment above 3 million and led to negative growth rates until 1993. In this volatile domestic economic context, the 1980s was a period of hostile relations with Europe as Thatcher's antipathy to European integration disrupted Britain's relations with the Continent. Globally, this was generally a time of deregulation of international trade and investment. GATT became the World Trade Organization in 1995, and shifted its emphasis to reducing barriers to trade in services. International financial activity accelerated as capital controls in Britain were finally abandoned in October 1979. Figure 26.4 shows that the value of international capital flows increased dramatically thereafter.

The Thatcher government fought a running battle with the European Community over various aspects of harmonization and integration. The lack of commitment to the European 'project' pushed Britain to the sidelines in these decades while continental governments developed plans for economic and monetary union. Britain's economic relations with the Continent were dominated by exchange rate policies as Europe sought to ensure exchange rate stability and ultimately a single currency, while Britain hoped to maintain its independence.

In 1971 EEC members pledged to achieve economic and monetary union by 1980. However, the plan was abandoned in 1973 because of the turmoil of the oil crisis and the economic chaos that ensued. In an effort to rekindle the momentum towards further integration, the European Monetary System was formed in 1979, creating a grid of fixed exchange rates called the Exchange Rate Mechanism or ERM. Under this system currencies were pegged to an artificial currency known as the ecu, which was valued as a weighted basket of all members' currencies. The ecu was valued according to a formula that gave 32 per cent to the Deutschmark, 19 per cent French franc and 15 per cent to the pound, reflecting their relative strengths and the fact that Germany (not Britain) was the effective standard of the system. The EMS was more modest than European Monetary Union, or EMU, seeking only a zone of monetary stability rather than immutable exchange rates or a common currency. Nevertheless the Thatcher government rejected it as inimical to the monetary policy priorities and sovereignty of the British state, and so sterling was not part of the ERM. In the event, the ERM did not prove completely successful: from 1979 to 1987 there were 11 realignments of one or more currencies or 27 changes in parity due to failure to co-ordinate economic policy and achieve the convergence of national inflation rates that is required for stable exchange rates.

As British policy priorities changed from targeting the growth of the money supply, momentum grew for the UK to enter the ERM, but Thatcher and her advisers successfully resisted this pressure until 1990. In 1986 oil prices fell sharply, threatening North Sea oil revenues, and sterling depreciated steeply, falling 25 per cent against the Deutschmark over the year. As Britain hovered on the sidelines, the EU committed itself in 1986 to a single market by 1992. In 1989 Jacques Delors launched the programme towards economic and monetary union. A year later, in October 1990, sterling finally joined the ERM with wider bands for fluctuation (+/− 6 per cent) than other countries. Three months later the EU governments committed

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themselves to achieving EMU no later than 1999 at a summit in Maastricht. Once again, European integration forged on ahead of the pace of British political opinion and Britain opted out of key elements of the Maastricht treaty.

Sterling's brief experience in the ERM was not a happy one, although inflation and interest rates did fall. However, with relatively high interest rates drawing capital to Germany, other European currencies came under pressure. The Italian lira was devalued on 13 September 1992, and intense speculative pressure built up against sterling in expectation of another devaluation. The transfer of sterling to the government as a result of its foreign exchange transactions supporting the pound in the third quarter of 1992 amounted to £13.1 billion, most of which related to support of the pound on 16 September.[20] This level of support was ultimately unsustainable, and sterling dropped out of the ERM that day. The legacy of this experience was to make those among the British public and politicians who were already sceptical about European integration wary of further moves towards fixed exchange rates. Those more friendly to integration came to appreciate the importance of choosing an appropriate rate and terms on which to join the future single currency. At the end of the millennium this debate remained unresolved, and on 1 January 2002 the European single currency was at last inaugurated without British participation.

Conclusion

The experience of Britain in the international economy in the second half of the twentieth century is often characterized as one of decline. During and immediately after the Second World War Britain played one of the most important roles in framing post-war economic policy through Anglo-American co-operation and sterling area relations. Britain ran one of the world's key reserve currencies and was the centre of a payments system that accounted for half the world's trade. With the recovery of Europe, and later Japan, the launch of the integration project on the Continent, and the industrialization of a plethora of new trading countries, Britain's position in the international economy inevitably became less prominent. Nevertheless, Britain's share of international financial flows well outpaced the prominence of goods trade, or even the size of the British economy as a whole. On the other hand, at the same time as Britain's share of international trade was falling, international trade and international investment became much more important to the British economy due to the very rapid expansion in global commodity and capital flows, especially from the 1970s. To categorize British performance in the international economy as one of self-imposed decline is, therefore, too simplistic. Instead, this chapter has emphasized the many ways in which the international economy itself changed and the various ways this affected Britain's role in it.

NOTES

1 Maddison, *Monitoring the World Economy*, p. 38. These figures are not directly comparable with ONS data used in the rest of this chapter.
2 Hinds, *Britain's Sterling Colonial Policy and Decolonization.*
3 Choi et al., 'Banks and the World's Major Banking Centers'.

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4 Pecchioli, *The Internationalisation of Banking*, p. 19.
5 Bank for International Settlements, annual reports.
6 Argy, *The Postwar International Money Crisis,* p. 92.
7 GDP, trade and investment data are at current prices and seasonally adjusted, published by the UK Office of National Statistics.
8 Schenk, 'Britain and the Common Market'.
9 Bostock and Jones, 'Foreign Multinationals in British Manufacturing'.
10 Steuer et al., *The Impact of Foreign Direct Investment on the UK*, p. 189.
11 Pain, 'The Growth and Impact of Inward Investment in the UK', p. 6.
12 Jones, *British Multinational Banking*, p. 358.
13 UNCTAD, *World Investment Report 2002.*
14 Ibid.
15 Pollard, *Britain's Prime and Britain's Decline*, p. 61.
16 Obstfeld and Taylor, 'Globalisation and Capital Markets'.
17 Woodward, 'The Search for Economic Stability', p. 66.
18 Argy, *The Postwar International Money Crisis*, p. 89. Net oil payments are expenditure on oil imports less exports to OPEC.
19 Schulze and Woodward, 'The Emergence of Rapid Inflation'.
20 *Bank of England Quarterly Bulletin* (1992).

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