Britain's changing international interests: economic influences on foreign policy priorities

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Even though the age of gunboat diplomacy has passed, the linkage between national economic interests and foreign policy objectives remains strong. It is a linkage that transmits both ways and that is relevant across the political spectrum. In the Eastern bloc countries, foreign economic policy is an acknowledged means to political ends. Yet the domestic economic costs of some security decisions, such as the arms race, cannot be ignored. For countries in the West the situation is sometimes the other way round, so that external economic influences are considered so important that they dictate national positions (or more often the lack of them) on international political issues such as terrorism or third-party aggression.

While recognizing that it is the interplay of several factors—not only economic but military, strategic, political and other considerations that have little to do with economics—that shapes foreign policy decisions, this article will focus only on the economic aspects of the formation of national foreign policy priorities. It is not that these are of paramount importance, but rather that the implicit assumptions of foreign policy-makers about their country's role in the world economy and its external economic interests have an important but largely unexamined bearing on the political choices that are made. In Britain's case, the natural bureaucratic divisions between Foreign Office and Treasury, the propensity of academic economists for turgid jargon and mathematical formulae and the tendency of press reporting to focus on immediate news rather than basic economic trends are all factors that contribute to a gap between underlying economic changes and current political debate.

The world economy is currently undergoing structural changes whose domestic economic impact is not yet widely recognized in Britain. Outdated attitudes that focus on industrial decline and losses of historical market share in certain export categories carry with them the risk that important new opportunities for an effective British foreign economic policy will be missed. If Britain's economic interests in this changing environment are to be identified, the traditional view of economic links with the rest of the world will need to be broadened and the public debate on the new options available become better informed.

In the first section of this article we will review the recent history of Britain's role in the international economy and how that economy has changed. In section two we will then identify three structural changes of significance to Britain's current and future position: the internationalization of business activity, the changing balance between manufacturing and service industries, and the legacy of oil exports. The impact of these changes on Britain's external economic position will be traced in section three, with

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0020–5850/87/3/0375–19 $3.00

The improvement has not been uniform across all export categories. In manufactured goods the UK world market share fell from 7 per cent in 1973 to 5.6 per cent in 1985. Over the same period, however, Germany's share fell from 17 per cent to 13 per cent—a much steeper decline. Meanwhile, Japan and the developing countries gained market share in manufactures. It is the sign of a growing world economy that over the course of more than a decade, shifts in comparative advantage occur which are reflected in trade flows. As a corollary of this, partial comparisons based on export categories with traditional historical importance are likely to be a misleading guide to a country's overall international competitiveness.

Again, the contrast with the United States is striking. The United States was never as dominant in world trade as it was in world output; in 1973 the United States produced 12.5 per cent of world merchandise exports. The rapid rise of Japan, the developing countries and, to a lesser extent, Germany in the export markets since then reduced the US share to 10.7 per cent in 1985, and provisional figures for 1986 show Germany overtaking the United States as the leading world exporter, despite its own loss in market share.

Such trends suggest *not* that the United Kingdom is rapidly losing ground in the world economy, but that its postwar decline has been stabilized and possibly even reversed. Meanwhile, the major economic change of the last decade and a half is the erosion of the dominant position of the United States. This point, and its implications for the United States, were summarized by C. Fred Bergsten in a recent report to the Trilateral Commission:

> In essence, the United States thus faces something of a scissors movement. On the one hand, its dependence on the world economy is rising. On the other hand, its power to dictate global economic outcomes has declined. The obvious implication is the need, from a purely national American standpoint, for more effective international economic arrangements. (The same need arises from a global systemic standpoint, because of the decline of the 'hegemonic power' and thus a requirement for pluralistic management to replace it.)[4]

What does this imply about the role of Britain in the foreign policy field? Britain's quantitative importance in the world economy is not large, but it is no longer shrinking. Meanwhile the relative decline of the United States—and the changes in Japan, Germany and elsewhere that have brought it about—imply that the role of middle-ranking countries that can act effectively in multinational forums will become more important. Thus Britain's scope for pursuing foreign policy objectives may actually be increasing—but, as argued below, different strategies and skills will be needed to take maximum advantage of the new opportunities.

Structural changes in the world economy

Just as the changes in Britain's role within the world economy have resulted more from changes in the world economy than from domestic developments, two of the three structural changes to be discussed below are worldwide phenomena: the internationalization of business activity, and the changing balance between manufacturing and service industries. However, in Britain's case the effect of these two factors has been

4. C. Fred Bergsten, 'America's unilateralism', in *Conditions for partnership in international economic management* (The Trilateral Commission, 1986).

discussed below, in the level of domestic employment. The erosion of the distinction between trade and capital flows makes it increasingly misleading to judge the performance of British industry by its trade balance.

The changing balance between manufacturing and service industries

The second international trend which has affected Britain's external accounts is the apparent shift in many industrialized countries from manufacturing to services in both output and employment. Perhaps because reliable data on services do not yet exist in many countries, this is a shift that has been widely misunderstood. For example, in the United States, where it has proceeded faster than in other industrial countries, the initial public reaction was anguish at the 'deindustrialization' of America. It is now clear, however, that much of the growth in service industries has resulted from changes which have taken place *within* the manufacturing sector, in its attempt to benefit from economies of scale in services by buying in functions which were once performed in house (from software development to office cleaning), and to take advantage of advances in production technology, such as computer-integrated manufacturing.

The United States' example is enlightening. Between 1973 and 1985 the gross volume of manufacturing output grew by about 40 per cent, while over 5 million blue-collar jobs were lost. Robotics and the automation of production—*not* import penetration—accounted for most of this change. Yet during the same period overall employment grew faster than in any comparable peacetime period. The entire growth was in non-manufacturing, non-blue-collar jobs. Thus, as Peter Drucker has put it, 'It is not the American economy that is being deindustrialized. It is the American labor force.'[7] Moreover, the new service jobs in the United States have not been primarily in the low-skill, low-wage sectors. Only a third of the service jobs created since 1973 are in retail and wholesale trade. The growth is spread over a wide range of high-skill, high-status, capital-intensive sectors, such as health care and information processing.[8] These offer as much scope for future growth in productivity, and hence in incomes, as traditional manufacturing employment.

On computer-integrated manufacturing, Dr Bruce Merrifield, US Assistant Secretary for Productivity, Technology and Innovation, predicts:

> The manufacturing facility of the very near future, within five to 10 years, will become computer-integrated flexible. A given plant will make hundreds of products for different companies and different industries, serving hundreds of different niche markets. It will run for 35 minutes on one thing, 20 minutes on another. Manufacturing itself will become a service function.[9]

And Drucker concludes:

> It is quite unrealistic, for instance, to expect that the American automobile industry will employ more than one-third of its present blue-collar work force 25 years hence, even though production might be 50% higher . . . A country, an industry or a company that puts the preservation of blue-collar jobs ahead of international competitiveness (which implies a steady shrinkage of such jobs) will soon have neither production nor jobs.

7. P. F. Drucker, 'The changed world economy', in *The McKinsey Quarterly*, Autumn 1986, p. 10.
8. *The Economist*, 7 Feb. 1987, p. 43.
9. *The Times*, 16 Feb. 1987.

Table 1: Proportion of workforce employed in service sector (%)

	1970	1975	1980	1985
UK	49	55	59	65
West Germany	42	48	50	54
Japan	47	51	55	57
USA	61	65	66	68

Sources: OECD Quarterly Labour Force Statistics; Employment Gazette.

from 33 per cent in 1970 to around 25 per cent by 1985; in Germany over the same period manufacturing output fell from 35 per cent to 33 per cent.

What are the trading and investment implications of this changing balance between manufacturing and service industries? First, although it is beyond the scope of this article to explore, changes in the national education system—to encourage adult retraining and to improve the average qualification of labour-market entrants—will be necessary, both to mitigate unemployment in the short term and to provide the degree of competence and flexibility that will be required in the future for Britain to remain internationally competitive. Japan has already begun to move in this direction by commissioning a major study of its long-term educational priorities to meet the needs of an information-based economy.

Secondly, the expanding demand for services is likely to create expanding opportunities for service trade. This is an area where Britain is already strong. Some expansion will be counted in invisible transactions (e.g. certain banking services, insurance, consultancy, telecommunications). Much of the expanding service demand, however, will be met by overseas investment rather than by exports (for instance in retail banking, hotels, retail trade, some consultancy and insurance operations). For the banking sector in particular, the distinction between overseas investment income and an export of services is a fuzzy one. Thus, in services as well as manufacturing, it is important to look beyond the trade balance to assess international competitiveness and external policy priorities.

The legacy of oil exports

The two trends discussed above have affected all industrialized countries. In Britain, their effects have been reinforced by the coincident emergence of oil export earnings. This has happened in two main ways: through exchange-rate pressures, and through overseas investment of part of the capital surplus.

First, rising oil prices have led to an appreciation of sterling during the 1979–82 period which, other things being equal, would decrease the competitiveness of Britain's non-oil exports. There are several ways in which British industry could respond. One would be to try to hold market share overseas by reducing profit margins and tightly controlling domestic production costs. This is apparently how many Japanese industries are reacting to the rising yen. However, there is little evidence that British industry was actually able to reduce its labour and/or other costs so as to offset sterling appreciation. For four of the five years between 1979 and 1983,

> [the Quarterly Bulletin]. It cannot be said that our understanding of inter-country flows is other than primitive and it is certainly not backed by the kind of statistical analysis that supports sectoral financing accounts.[15]

Despite difficulties with the figures available, it is worth exploring how the structural relationships in Britain's external accounts have changed, and what these changes imply for foreign policy.

The growing importance of the capital account

The internationalization of business strategy and the emergence of Britain's capital surplus as a result of oil exports have combined to lend growing importance to capital account transactions. It is no longer appropriate to regard changes in the investment flows simply as mirroring movements in Britain's current account. Both direct and portfolio investment have become driving forces in their own right.

In the case of direct investment, at the end of 1985 British overseas assets amounted to £77 billion, of which more than 85 per cent was held by industrial and commercial companies. It is estimated that about 60 per cent of total overseas assets are located in North America, where economic growth has been higher than in Europe since the recovery began in 1982.[16] One might expect direct investment to have been higher in North America than in Europe for another reason too: lower transport costs and the absence of tariff barriers between the United Kingdom and the other European countries would encourage trade rather than direct investment by a multinational company interested in the European market. The fact that the same company might choose a direct investment strategy for the North American market illustrates why it is misleading to look only at export and import flows when discussing Britain's main 'trading' partners.[17]

The bulk of *inward* direct investment—that is, foreign firms investing in the United Kingdom—is also from North America. Leaving aside investment by oil companies, the United States and Canada invested a total of £6.2 billion in the United Kingdom between 1977 and 1983—over half of the total inflow. Table 2 shows the net direct investment flows between Britain and other countries for this period.

To the general public, or to 1985 Reith Lecturer David Henderson's 'do-it-yourself economist', it may be worth explaining the rationale and the mutual benefit that drive such inward and outward investment flows. Why, one may ask, should UK firms invest in the United States while at the same time US firms are investing in the United Kingdom? The underlying rationale is the same as that for international trade: firms in each country possess an expertise or cost advantage that enables them to provide a better service than home firms to an element of the world market. For example, a UK conglomerate may have developed a type of management expertise that it feels would be well suited to improving the sales of an American retail chain. A US company with worldwide marketing expertise in computers may want to invest in a British software

15. Sir Alec Cairncross, 'One hundred issues of the Quarterly Bulletin', *Bank of England Quarterly Bulletin*, Sept. 1985, p. 381.

16. 'Overseas direct investment in 1984', *Business Monitor*, 1984, p. 4.

17. This hypothesis is not well supported by data from France and Germany, however, where one might expect the same reasoning to apply. During the 1980–4 period, 27 per cent of Germany's overseas direct investment went to the United States while 30 per cent went to other EC countries. Over half of French direct investment is within the EC, compared to about one-quarter in the United States. Perhaps the Anglo-American 'special relationship' still applies to direct investment.

Table 3: Britain's current account balance, 1981–5 (£bn)

	1981	1982	1983	1984	1985
Visible trade (exports less imports):					
Oil	3.1	4.6	7.0	6.9	8.2
Non-oil	0.3	−2.3	−7.8	−11.3	−10.3
Visible trade balance	3.4	2.3	−0.8	−4.4	−2.1
Invisible trade (exports less imports):					
Services	3.9	2.6	3.7	3.7	5.8
Interest, profits & dividends (IPD)	0.9	1.0	2.4	4.2	3.4
Transfers[a]	−2.0	−2.0	−2.1	−2.3	−3.5
Invisible trade balance	2.8	1.6	4.0	5.6	5.7
Current account balance	6.2	3.9	3.1	1.2	3.6

[a] About half of which is government transfers to the EC.
Source: Central Statistical Office, *Pink book*, 1986.

imports as a result of the recession. Table 3 summarizes Britain's current account balance for the period since 1981. The visible trade portion is easily understood. Service exports include sea transport (a growing negative balance in recent years), civil aviation (a small positive balance), tourism (another small positive balance) and banking, insurance, consultancy and other services (amounting to a net contribution of £7.3 billion in 1985, more than offsetting the deficit on shipping). Both insurance and banking services, in particular, are large and growing contributors to Britain's surplus on invisible trade. Over the last decade net overseas earnings from banking and insurance services have grown at average rates of 22 and 25 per cent per year.

Not only are these services important to Britain's external balance, but Britain's financial sector is clearly important to the growing world market for such services. By the second half of the nineteenth century London was well established as the centre of international banking and capital markets. Although its pre-eminent role has been eroded somewhat in the 1980s as the United States and Japan have moved strongly into the arena, at the end of 1985 banks located in the United Kingdom held one-quarter of outstanding international claims—a market share twice that of the United States or Japan. London had 30 per cent of the Eurobanking activity, with Paris second at 8 per cent. International banks in London have in the past borrowed mainly from Switzerland, the United States and OPEC countries, and lent mainly to Japan, the rest of Europe and Latin America.[19] The roles of the United States and Japan are likely to be reversed over the coming years.

19. Andrew Lamb, 'International banking in London, 1975–85', *Bank of England Quarterly Bulletin*, Sept. 1986.

Priority issues

The two issues on the current international economic agenda that are of clear importance to Britain are the liberalization of trade in services and the safeguarding of international investment flows. Both of these are part of the new round of GATT negotiations; but it is unlikely that Britain's interests will be effectively pursued if GATT is the only vehicle used.

This is so, first, because the definition of the topics on the GATT agenda does not fully match Britain's concerns. The negotiations on services will try to define both general principles and specific codes for certain (not yet selected) service industries. These may or may not be those in which Britain has a particular interest—insurance, banking and air transport. Only 'trade-related' investment rules (such as minimum requirements for local content) will be discussed. But portfolio flows and the regulation of international financial markets are of at least equal importance to Britain.

Secondly, the Commission of the European Community (EC) negotiates collectively for its member states in the GATT. Britain leads the Community in the competitiveness of its service industries and the openness and sophistication of its financial markets. It is noteworthy that, since Britain joined the EC in 1973, the proportion of the United Kingdom's total service exports going to other Community countries has fallen from 33 to 26 per cent, while the proportion of total goods exports to the rest of the EC has risen from 32 to 49 per cent. The slow pace of progress within the EC on liberalizing service trade and investment flows suggests that British enthusiasm for these reforms is not fully matched by its European partners. Trade-offs will be necessary in agreeing the EC negotiating position, which itself will be only a starting-point for GATT discussions. One effect of this process will be to muffle Britain's voice on the issues of greatest importance to Britain. Whether or not that is compensated by the enhanced effect of the EC speaking as one will depend on the common position adopted and the skill with which it is pursued.

In the area of services, trade liberalization involves such issues as the right to establish offices in other countries and the mutual recognition of professional qualifications. These issues are part of the current Community effort to complete its internal market by 1992. Britain should continue to play a leading role in developing workable formulae in the EC context, not only because of the undoubted importance of the EC market to UK service industries, but also as a model for application either through the GATT or bilaterally.[21] Because many of the barriers to services trade are more complex than those which affect goods, and because service industries themselves are so diverse in the way 'trade' is carried out, progress in liberalization is likely to proceed from detailed industry-level arrangements between countries with clear mutual interests. In the banking and insurance fields particularly, Britain is well placed to play a leadership role.

International investment issues have a broader context than trade policy. The basic means to safeguard the interests and retain the flexibility of Britain's overseas investments (both direct and portfolio) is a sound international financial system. That system has undergone considerable strain over the past 15 years, with the recycling of the OPEC surpluses, the rescheduling of developing country debt and, more recently, the effects of the large external imbalance between the United States and Japan.

21. The United States has followed this approach in developing a bilateral code on service exports with Israel as a model for other bilateral and for multilateral agreements.

instruments that will move it in the desired direction, rather than simply plugging loopholes and reacting to problems as they arise. Should the international market in securities eventually consist of one central trading system with worldwide access, or should cross-listing of companies on the major stock exchanges provide the main international link? Where should the 'ring fence' separating financial markets from others be placed, given considerations of consumer protection as well as market efficiency? Fences between banking and brokering are being lowered in the United States and Japan, while 'Chinese walls' are being erected in London—yet abuses of both systems are increasingly coming to light.

This kind of issue is beyond the scope of central bankers or enforcement agencies alone, which are themselves subject to jurisdictional fences. There is a clear role here for government to play in taking a longer-term perspective on financial market development and in defining the central issues as they affect Britain's competitive position.

Geoeconomic implications

Britain's economic interests are remarkably widespread. Trade flows are widely diversified, with no single country accounting for more than 15 per cent of total imports or exports. As shown in Table 5, the United States and Germany are the United Kingdom's largest trading partners, followed by other European countries.

Table 5: Geographical distribution of UK trade in goods, 1985

	% UK exports	% UK imports
EC	49	49
—of which West Germany	11	15
France	10	8
Italy	4	5
Netherlands	9	8
Ireland	5	3
Other Western Europe	10	14
USA	15	12
Japan	1	5
Other developed countries	5	5
Developing countries	18	13
Centrally planned economies	2	2
Total	100	100

The EC as a whole accounts for nearly half of both exports and imports of British goods. Commonwealth countries account for about 11 per cent of UK exports and 8 per cent of imports. As a trading partner, Japan is less significant than Italy. Britain's largest positive bilateral trade balance is with the United States, while the largest negative balance is with West Germany.

The tactical options

While geoeconomic considerations do not imply limiting Britain's horizons to particular areas, the tactical choices for influencing international economic developments do require decisions about the issues and forums on which to concentrate. It was argued above that, as the United States' hegemony in the world economy declines, international economic collaborations are likely to become more important in the decision-making process of the largest countries. This has several implications for the options open to Britain in pursuing its foreign policy objectives.

First, there is at least the potential that the influence of 'middle-ranking' countries will increase as pluralism replaces the unilateralism of the big countries. Coalitions are critical in pluralistic decision-making, and that enhances the voice of smaller partners. Talk of a trilateral world—the United States, Europe and Japan—is fashionable today; but the economic indicators suggest it is rapidly becoming an even more complex multilateral world with overlapping networks of common interest groups in fields such as environmental issues, agricultural trade, financial liberalization, developing country debt, and so on. Britain must be adept at seeking out appropriate coalition partners according to the issue at stake.

Secondly, however, as economic integration proceeds—as the network of investments by multinational firms grows denser, and as the capital markets of the world's major economies merge into a seamless round-the-clock operation—the scope for policy action generally by governments will diminish. A government that tries to stimulate demand by lowering interest rates, for example, will find itself subject to an immediate judgement by actors in the foreign exchange markets which may neutralize the effects of the stimulus in advance.[28] Domestic firms with international interests will be quick to point out differences in tax treatment or labour laws that put them at a competitive disadvantage compared to their multinational rivals. This 'privatization' of international economic relations suggests that foreign policy initiatives will need to be based on a sophisticated understanding of underlying economic forces. The economic dimension of foreign policy analysis will grow in importance, even as the scope for independent government action diminishes. For Britain, this may mean a different mix of skills in the Foreign Office, or a different division of labour with staff from other departments in the embassies.

Thirdly, the existing multinational bodies in the economic sphere are likely to gain in importance as the United States grows to appreciate the need for the function they can fulfil in shaping and implementing coordinated policies. The 'Baker Initiative' to assist the developing-country debtor nations marked a dramatic turnaround in the Reagan administration's view of the usefulness of the World Bank. This turnaround may have been prompted by pressures from the US banking community and exporters who were badly hit by the slump in Latin American purchases, but it also represented a recognition by the US administration of an important area of North–South interdependence, and the usefulness of multilateral bodies for addressing mutual problems.

If organizations such as the International Monetary Fund and the World Bank do assume greater importance in international economic management, Britain will find itself with an appreciating legacy. Because of its central role in the creation of those

28. A similar point was recently made by Sir Geoffrey Littler, who suggested that such forces may lead governments to eschew demand management attempts and focus their efforts on longer-term supply-side measures such as education and training.

is complaint about relatively minor trade matters. Trade restrictions certainly exist (on whisky, for example)—but even if their removal were to triple British exports to Japan, the Japanese market would still account for less than 5 per cent of total UK exports. Worries about import penetration by the Japanese are similarly exaggerated; the United Kingdom imports more from Norway (or the Netherlands or Italy) than from Japan. Britain's biggest bilateral trade deficit is with Germany, not Japan. There is a danger that short-term trade friction may set back the development of a relationship which would have lasting benefits for both parties.

The scope for economic gain in dealing with Japan is through investment, not trade. Japan will be a significant capital exporter until well into the 1990s, and its intention to increase overseas direct investment is clear. The Japan External Trade Organization estimates that only 4 per cent of Japanese companies' production is carried on outside Japan, compared with 20 per cent for West German firms and 17 per cent for American ones.[30] Much of the new Japanese investment will go to the Pacific rim countries (including the United States), but Britain should unambiguously declare its interest in acting as the 'gateway to Europe' for Japanese companies. The advantages of language and of open capital markets are significant. Between 1951 and 1983, Britain attracted twice as much Japanese investment as any other European country. In addition to the macroeconomic and employment benefits of such investment, a recent review of Anglo-Japanese collaboration showed that Japanese-owned companies in Britain had been highly successful in transfering managerial and advanced production skills, as well as in developing good labour–management relationships.[31]

Finally, a more broadly based foreign economic policy requires the support of a public whose economic understanding goes beyond an unconscious devotion to mercantilist notions of trade. The world economy has long since surpassed that stage. If the political rhetoric in Britain continues to bemoan the loss of dominance in manufactured export markets, Britain will be in danger of losing the advantages and policy leverage which it currently enjoys in important growth areas of the increasingly integrated world economy.

30. *The Economist*, 7 Feb. 1987.
31. L. Turner, *Industrial collaboration with Japan* (London: Routledge & Kegan Paul for RIIA, 1987).