Summary points

- The UK’s role in the world is inextricably linked to its economic strength and prosperity. Maintaining a vibrant economy and financial stability is vital to enable the UK to benefit from global growth and pursue its ambitions at home and abroad.

- Britain’s international influence, in turn, complements and supports its comparative advantages in global services and investment. Such support would be less important for economies dependent on consumer-brand businesses and commodity trade.

- Leveraging global growth will be a critical determinant of the UK’s economic prospects, along with management of fiscal adjustment. Out of the wide range of forecasts for future growth, the final outcome will be dictated by the interaction between these two key drivers.

- In the best-case scenario, *New Vigour*, successful consolidation of public finances, combined with a return to robust growth, should ensure a broad continuation of Britain’s influence in international economic affairs. The UK can remain one of the top-ten largest economies, a strong performer among advanced countries for many years to come.

- Failure to manage fiscal adjustment and leverage global growth, however, will lead to the worst-case scenario, *A Lost Decade*: policy-makers would be forced to adopt ever tougher budgets, including cuts in protected areas of public services. A poor economic performance would also risk a precipitate loss in global standing and influence.

- The UK must prepare for such contingencies as a prolonged slump in the Eurozone or a global sovereign debt crisis by acting swiftly to boost confidence in both its ability to manage the public sector and its aspirations for future, sustainable growth.
Introduction

The starting position of this paper is that national prosperity, founded on sound economic management, is key to the UK’s influence in the international economic sphere and, more contentiously, that such influence helps sustain its prosperity. The pursuit of influence at the global level is justifiable as it facilitates the UK’s attainment of its economic goals at home and abroad – which encompass good governance, free trade in goods and services, open capital markets and mutual recognition of professional standards. History has given Britain a privileged position in international affairs and organizations, and has created a dense network of relationships at institutional, cultural and personal levels. All of these have been important in leveraging economic influence.

Arguably, the intricate interdependence between influence and economic performance is far stronger for the UK than for economies dominated by trade in global brand names and commodities, which sell themselves on world markets. This may be one of the explanatory factors behind Britain’s strong performance and comparative advantages in global services and investment, which together make a significant contribution to its economic growth. Notably, the UK is the world’s second largest exporter of services after the US and the wide-ranging role played by London has been a key element in this success.

While the UK remains one of the most important economies in the world, over the long run it is inevitable that all the advanced economies, including Britain’s, will experience a decline relative to those benefiting from catch-up growth in the developing world. This will be accompanied by a loss of entrenched predominance in the institutions of global economic governance. Nevertheless, a robust economic performance can slow the UK’s relative loss of rank and enable it to play to its broader strengths, as it did from 1980 to 2008: decline does not imply a dramatic demotion. Reputation and influence, meanwhile, do not depend simply on the size of the economy but on the perceived success of economic management in delivering stable financial conditions, high living standards, wealth creation and clusters of global excellence and innovation, whether in high-value-added services, manufacturing, education or other creative industries. Notably, the UK will remain one of the richest and most productive nations in the world, with a high level of GDP per capita (Table 1).

This strong performance will resonate with the emerging economies, which aim to attain the economic prosperity of the developed world. They admire and pay close attention to what works in promoting robust growth, looking to maximize their own chances of making successful transitions to highly productive, urbanized economies. As the UK is seeking to expand business relationships with these countries, it must be seen to be a prosperous partner, willing to share expertise and use its influence to support mutual aims, such as open markets. For this, it needs to play an active part in international institutions, especially where it can have an impact on events.

In this context, the paper explores the general concept of the interrelationship between the UK economy and its place in the world, suggests reasons for this linkage and indicates how potential shifts in the economy and in policies may affect Britain’s international standing and influence. It examines future scenarios for the UK economy, specifically how fiscal retrenchment (and the government’s broader policy choices) will interact with the global outlook to create a range of outcomes from New Vigour to A Lost Decade. The authors discuss the implications of these scenarios for the UK’s channels of influence in international economic affairs, and summarize the conclusions that may be drawn regarding the actions necessary to ensure Britain’s future economic stability and security.

1 ‘Influence’ is taken here to mean the ability to put forward arguments that modify opinions, rules and outcomes.
2 As described in companion papers in this series, in particular Robin Niblett, Playing to its Strengths: Rethinking the UK’s Role in a Changing World (London: Chatham House, 2010).
The importance of the UK’s economy

Britain continues to wield considerable influence in global economic affairs through its important contribution to the world economy and its activist approach to global governance – via its role in the G20, for example. Confidence is also demonstrated by its strong performance across a range of systematic studies and surveys. Indeed, despite more than a century of relative economic decline, the UK almost succeeded in stabilizing its share of world GDP from 1980 up to the crisis in 2008 (Figure 1). This contrasted with a sharper decline for the Eurozone countries (especially Germany).

If the economy can recover strongly and sustain a robust growth rate (above 2%), the UK has the potential to remain one of the world’s ten largest economies beyond 2020, according to mainstream forecasts. Notably, GDP per capita could surpass that of slow-growing Germany well before 2030. Demographic trends could also contribute to the UK overtaking Germany in terms of total GDP around this time (in fact, the UK is predicted to become the most populous EU state by 2050).

As shown by the countries listed in Table 1, in most cases economic size is closely correlated with economic power and global influence. Yet the UK’s position in the world economy is complex. It does not derive solely from the size of the economy but also from its adaptability and openness, which enhance its ability to shift specialization in reaction to developments in the global economy. Its position also reflects the success of London as one of the world’s most important business, educational and cultural hubs.

### Table 1: Rankings by size of GDP in current $US, 1990–2030

<table>
<thead>
<tr>
<th>GDP estimates (current $US trillion)</th>
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<td>India</td>
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<td>9-10</td>
<td>Brazil, Russia</td>
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<td>World total</td>
<td>23</td>
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Sources: IMF and UN data and own extrapolations to 2030, broadly matched by other estimates (allowing for variations largely due to the units used: for example, PwC use GDP at PPP, Goldman Sachs real 2003 dollars). See also Figure 1 and Figure 5 (footnote on forecasts).

* Some other countries rank highly in GDP/capita (over $40,000), notably Australia, Canada and smaller countries including Hong Kong, Singapore, Switzerland, Norway, Ireland, Qatar and Luxembourg.

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3 For example, in the City of London’s Global Financial Competitiveness Index 7 (GFCI-7), published in March 2010, London and New York are ranked equal as the most competitive global financial centres (although London has slipped in terms of point score and its previous lead over New York). The World Economic Forum’s Financial Development Indicators (2009) also place the UK in first place, and London is highly ranked in Foreign Policy’s Global Cities Index 2008 (15 October 2008).

4 Depending on the measure used, Maddison estimates that the US overtook the UK in terms of total GDP in the late 19th century, whereas US GDP/capita remained lower than the UK until the early 20th century (online database Maddison, A. (2010) ‘Historical statistics of the world economy, 1-2008 AD’, at: http://www.ggdc.net/maddison/).

5 The United Nations Department of Economic and Social Affairs forecasts that the UK will overtake Germany by 2045–50, based on the medium variant and rounded to the nearest 100,000. World Population Prospects: The 2008 Revision – Population Database (UNDESA, 2009).

6 Evidence is provided by the UK’s ability to attract FDI and headquarter operations; see data provided by Think London and by IBM in London 2020: Competing in a New FDI Era (March 2010), and also the Fortune Global 500 (20 July 2009), ‘Cities’, in which London ranked fifth after Tokyo, Paris, Beijing and New York in terms of the number of Fortune 500 companies headquartered, and ranked fourth by total size of these companies.
By activity and geography, the services sector and London have been the leading drivers of growth in the UK for many years. The contribution of services is shown by the increase in its share of gross value added (Figure 2), rising from just under 55% in 1970 to approximately 75% today. This also demonstrates Britain’s ability to adapt and change. In total, services accounted for nearly 50% of the growth in total expenditure in the UK economy over the last decade and 60% of the rise in exports. Similarly, by geographical breakdown, London (with 12% of the total population and about 15% of employment) accounted for 21% of the UK’s GDP in 2007 and contributed an average of 23% to GDP growth between 1998 and 2007 (the next highest contributor was the Southeast with an average of 16%). About half of this growth was due to the financial sector. Notably, London has also provided approximately 19% of the UK’s tax take, contributing to redistribution of the benefits of growth.

The financial sector’s reputation and value have been called into question as a result of the crisis and the subsequent surge in criticism of its activities. Yet although the image of some businesses has been tarnished, activity and jobs growth suggest that international confidence in the professions (such as law and accountancy) and many aspects of financial services (such as insurance, currency and other trading activity) has remained stable or even improved. This is partly a tribute to the efforts made by the City itself to limit the impact of the global crisis on its international standing and to reiterate its commitment to professionalism and training. However, preventing the spread of negative repercussions, such as the loss of the UK’s AAA credit rating and migration of the City’s skilled workforce, remains a challenge.

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7 London’s financial services industry grew at about 8% annually, expanding as a share of London’s economy from 14.8% to 17.1% and accounting for 12% of UK growth between 1996 and 2006 (ONS data).

8 The Greater London Authority (GLA) estimated London’s tax revenue at about £93bn for 2006–07. Total tax receipts for that financial year were £486bn, so London’s share was about 19%. Furthermore the GLA reported that London has been a tax exporter since 1989–90 (except for 1993–94), with ‘exported’ tax revenues (i.e. surplus of tax revenue) to the rest of the country estimated at anywhere between £8.4bn and £18.4bn in 2006–07. See Filling the Coffers: London’s Tax Export (GLA, November 2008).


10 As highlighted by the Insurance Profession Task Force in ‘The Aldermanbury Declaration’, Chartered Institute of Insurers (March 2010), for example.
Reputational risks highlight the importance of a healthy economic background and emphasize how critical it is that the UK aligns its near- and long-term policies to successfully restore financial stability, maintain economic recovery and lay the foundations for future growth. Britain’s potential to leverage developments in the world economy, both sectoral (strong growth in business and professional services) and geographic (rising demand in Asia), will help drive the economy forward. Investment from abroad will be a critical element in this process. However, for this strategy to succeed, the UK must inspire confidence and be able to offer an attractive environment for businesses to thrive and retain high-performing staff.

There is increasing global competition for skilled professionals in business and financial services, IT, technology, creative industries, life sciences and so forth. Leading economies will vie with each other to attract and develop their shares of the world’s ever more mobile talent pool. This race will determine which countries gain the most from the post-crisis recovery in global investment and services. The factors that influence the location decisions of global talent will take on ever greater significance. They will have an impact on policy decisions from taxation, education, transport networks and urban planning to management of resources, immigration and domestic security, and international affairs in general.

These demands must be considered alongside those of the country as a whole. There are risks in an international strategy spearheaded from London and the Southeast if some parts of the country consequently see themselves as excluded from the benefits of trade and growth. Political success will depend on resolving conflicting priorities in ways that promote economic progress and business achievements – as well as satisfying UK voters – across the country. Policy-makers will have to be persuasive at home and influential abroad. They will need to look for ways to gain from global trends and to augment the impacts on investment and jobs accruing chiefly in London and the Southeast with efforts to promote complementary growth across the whole country.

Moreover, Britain must continue to vigorously develop business with the rest of the world if its economy is to grow during a period of inevitable fiscal austerity. Evidence from the last decade points to the substantial contribution that exports and FDI have already made to UK economic growth: an increase of £200 billion in these revenues between 1998 and 2007 accounted for almost
30% of the increase in total expenditure in the economy (equivalent to 40% of the rise in GDP). Services exports were the largest component of this external growth, rising by approximately £83 billion (the rest was split roughly equally between FDI and goods exports).

Looking ahead, can the opportunities linked to global expansion offset the negative effects of what is widely expected to be a decade of fiscal austerity? How can the relative impacts of these critical developments be assessed and how will they shape the outlook for the UK economy?

Scenarios for the UK economy: the decade ahead

Globalization and the expansion of credit and financial markets were the dominant economic trends over the last decade. The forces that will define the coming years are primarily the continuing impact of the burgeoning developing world in boosting global economic growth, together with the management of fiscal adjustment – a situation that is similar to the early 1990s but tougher. Success or failure in leveraging global growth and achieving consolidation in public finances will determine how well economies will perform.

These twin drivers, external and internal, define a set of four possible scenarios for the UK’s economic outlook. In our view of their order of probability, they are: New Vigour, A Lost Decade, Fiscal Failure and Old Partners. The two intermediate cases, Fiscal Failure and Old Partners, are likely to be unstable, probably converging on one of the two extreme cases. These
scenarios offer an intuitive overview of the way in which key factors interact to create varying forecasts for the economy. They broadly encompass the available range of estimates for GDP growth reported by both private and institutional forecasters (see footnote to Figure 5). Their main characteristics are as follows:

**New Vigour** is a high-productivity, robust-growth scenario, which sees the UK taking full advantage of opportunities offered by healthy global GDP growth (at peak rates of 4–5% in PPP terms) and strong UK fiscal management.

- Britain leverages globalization, especially rapid growth in the developing world, to promote its comparative advantage in trade in business, professional and financial services, along with specialized niches in manufacturing. This boosts FDI into the UK as well as exports, with a heavy geographic focus on the London area that is subsequently dispersed into impacts across the country. UK economic growth recovers strongly to the 2–3% range, similar to previous trends. Services are the main focus but manufacturing also sees a one-off surge in 2010–11, in part due to a weak pound. Improving job prospects stimulate consumer demand in spite of fiscal constraints.

- Tax revenues rebound rapidly and government finances are brought under control more quickly than expected, creating scope for policy concessions after a tough fiscal regime in 2010–12. Essential spending on infrastructure, education and skills might be a priority, but it would also present an important opportunity to loosen tax policy to foster business growth, investment and a strong talent pool.

- This scenario critically offers scope for reversing ‘crisis taxes’: tough short-term measures may be made more palatable, and less damaging, by the promise to review tax rates as soon as the fiscal position permits.

**New Vigour** would clearly set Britain back on track to regain its former strong position, boosting London’s global status and, arguably, helping the UK to maintain a significant degree of international influence within the context of the long-term decline in the power of the mature economies.

**A Lost Decade** is the worst-case scenario, with a combination of lower growth in the world economy (reverting to its old trend of 2–3% in PPP terms) and poor fiscal management in the UK (which may involve not only the scale but also the mix, timing and presentation of budget cuts).

- The UK’s economic recovery falters as a result of less buoyant global growth and poor domestic policy decisions, which provoke negative investor reactions to tax and regulatory changes and the loss of skilled professionals. Weak world growth also makes fiscal adjustment difficult for other countries and there would be a serious risk of a global sovereign debt crisis under this scenario.

- The UK’s public-sector debt/GDP ratio continues to rise to over 100% of GDP by 2013–14, damaging its AAA credit rating and pushing up its risk premium in international markets. This implies that debt interest payments alone could be as high as 7–9% of GDP by 2015. Britain is forced to adopt an emergency strategy to contain the damage and reduce public-sector debt. The debt crisis causes a prolonged slump, with growth averaging just 1%, in line with Japan’s performance during its ‘lost decade’ after the ‘bubble economy’ burst at the beginning of the 1990s.

- **A Lost Decade** implies much deeper public-sector cuts and job losses in all sectors. Taxes would also have to rise further, and immigration would become a greater political issue. In spite of a weak Eurozone and euro, a sterling crisis may materialize. The pound could thus drop below parity with the euro, stoking the threat of inflation and pushing up UK interest rates. This would only exacerbate Britain’s debt crisis and the negative confidence effects on the financial sector.
**Fiscal Failure** and **Old Partners** are the two intermediate, but probably unstable, scenarios:

- In **Fiscal Failure**, poor management of fiscal adjustment and economic policy lead to a loss of confidence in the UK, and London, undermining not only domestic demand growth but also trade in services and FDI. A weak pound and rising inflation would put pressure on market interest rates. Despite buoyant global growth, this policy and confidence failure would bring the UK’s average GDP growth down to 1–1.5%, with a further dip into recession possible. However, this scenario is unlikely to be stable as the British electoral system tends to punish failure. A change in government, if this improved the policy mix, might be able to successfully steer the UK towards the **New Vigour** scenario, helped by still buoyant global growth.

- In **Old Partners**, the UK begins to resolve its fiscal problems but global growth remains weak, primarily owing to an enfeebled Europe and, to some extent, fiscal constraints in the US. Knock-on effects damage growth prospects for developing economies, which also begin to face internal constraints from supply bottlenecks and inflationary pressure. Hence, Britain’s strategy has to become more limited and focused on its ‘old partners’ in Europe and the US, delivering lower and more volatile growth (1–2%)

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**Figure 4: Scenarios for the UK economy**

**Low global growth (2–3%)**

- **A Lost Decade**: A weak global recovery coupled with poor fiscal management leads to a UK debt crisis; indeed a global sovereign debt crisis is possible
  - The UK economy suffers from a prolonged slump: growth averages just 1% and debt levels remain stubbornly high, limiting government policy initiatives
  - Crisis management forces a rethink on how to pursue global influence and the role of the UK in Europe

- **Fiscal Failure**: Poor fiscal management erodes confidence in the UK and weakens the recovery despite the benefits of global growth
  - This has an impact on the UK’s financial standing (credit rating) and curbs services growth
  - Severe budget cuts have to be implemented as a weak economy makes it hard to stabilize the debt/GDP ratio

**High global growth (4–5%)**

- **New Vigour**: The UK successfully leverages global business opportunities
  - Tough fiscal policy coupled with rising tax revenues ensure the budget deficit falls rapidly; the debt/GDP ratio stabilizes by 2012 and concerns subside
  - Growth rapidly returns to robust rates in the 2–3% range and fiscal options improve, offering scope to ease ‘crisis taxes’ and austerity plans by 2014–15

- **Old Partners**: World growth reverts to its old, weaker trend owing to a very sluggish Europe and less buoyant emerging markets. This dampens UK exports, FDI inflows and economic growth in general, limiting the recovery
  - The UK has to rely more on business with old partners such as the US and Europe
  - This scenario may evolve into a **A Lost Decade** unless global growth can be improved, steering towards **New Vigour**

**Successful fiscal consolidation in the UK**

- **Domestic Policy Success**
  - The UK debt crisis
- **International Policy Success**
  - Low global growth (2–3%)
than under the stronger global scenario. Regional growth worldwide turns inwards, changing industrial and export strategies for other advanced economies as well as the UK.

- Arguably, the UK, perhaps acting in concert with other pro-growth countries, might improve the global performance behind Old Partners by exerting influence on international thinking towards more efficient and growth-oriented policies. This could transform Old Partners into New Vigour, providing an example of the use of soft power to enhance the global outcome, even though Britain’s direct economic clout alone (trade, finance etc.) would make this appear implausible.

- On the other hand, if global growth continued to be poor, the UK’s own fiscal adjustment would become more difficult to sustain under the Old Partners scenario, suggesting that it could tip towards A Lost Decade.

The New Vigour (high) and A Lost Decade (low) estimates for UK GDP are depicted in Figure 5, extrapolating forecasts from 2010 to 2020 using the trend growth assumptions indicated in the chart (and in the scenario descriptions). These outcomes are also compared with projections based on consensus forecasts for other advanced economies.¹¹

The components of UK growth also change in these scenarios (Figure 6). All of them envisage less emphasis than in the past on domestic consumption and the government sector (indeed the latter would have to shrink during the early part of this decade). However, consumers and investment suffer most under A Lost Decade because of poor fiscal management and job losses. There is generally expected to be a greater contribution from net trade, in part driven by weaker import growth. A robust export performance would be an obvious feature of New Vigour, serving to boost investment, overall GDP growth and jobs.

To explore these scenarios further and draw out policy conclusions and implications for the UK’s channels of international influence, the two driving forces behind future growth prospects – fiscal retrenchment and the outlook for the global economy – are analysed in more detail below.

¹¹ These are detailed in Figure 5, on the basis of estimates from the IMF and European Commission, although it should be noted that the figures were published before the outbreak of the Eurozone crisis in April–May 2010.
Fiscal retrenchment

From the UK’s standpoint, it is no longer helpful to continue the debate over the risks involved in premature versus delayed tightening. This has been overtaken by events, in particular the Eurozone debt crisis, and assessing the optimal timing would be almost impossible in any case. Indeed, this was clearly the dominant concern at the G20 finance ministers’ meeting in Korea in early June 2010 – a view also endorsed by the IMF. Under current conditions, if procedures are not implemented to bring large budget deficits under control, the risk of soaring debt will leave economies courting disaster, pushing up risk premiums, raising interest payments and potentially threatening to restrict governments’ access to international markets – in other words, a global sovereign debt crisis has become a significant risk. It is not wise for countries to test the dividing line between fiscal support for the economy and exceeding credible debt limits.12

However, it is unfair to portray Britain as financially profligate or to be overly pessimistic about its prospects. There is the scope, as well as the capability, to quickly reduce the threat of a UK debt crisis. According to headline figures for government debt, Britain was more prudent than its Eurozone neighbours until 2008, going into the crisis with a low level of government debt (just under 45% of GDP in 2007, compared with a Eurozone average of around 60%). Mounting anxiety over public-sector finances should be tempered by the fact that the UK’s debt position at the end of 2009, at less than 70% of GDP, was actually better than that of its EU partners,13 including Germany and France.

Nevertheless, the trigger for concern over the current state of the UK’s public finances has been the speed of deterioration in debt during the recession and the still high budget deficit (around 10% of GDP) expected for 2010. In addition, there is pressure to undertake a thorough review of the potential for

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12 This does not imply that all countries need to adopt fiscal austerity – policies must depend on budget positions and debt profiles. Arguably some countries even have scope to run larger deficits, helping offset the global impact of austerity in those countries most at risk from large deficits and mounting debt.

13 This refers to gross government debt, the definition used throughout this paper, as opposed to net government debt, which includes the financial assets held by the government as an offset to its liabilities. In the UK, net government debt rose from 36% of GDP in 2007 to 54% in 2009, and HM Treasury forecasts that it will peak at around 75% in 2014 – considerably lower than gross debt.
sustainable public expenditure. This is particularly necessary given that spending and jobs were allowed to rise sharply in recent years on the back of a cyclical boom in tax revenues from the property and financial markets – revenue that may never fully recover.

The immediate target of fiscal policy should therefore be to reduce the 2010–12 budget deficits enough to reinforce confidence in the government’s ability and willingness to control public finances. Debt reduction cannot be delivered quickly but a determined move in the right direction will suffice. The testing part of the strategy will be to find ways of quickly raising revenue and cutting costs while limiting the risks to the economic recovery, preventing damage to the most critical drivers of long-term economic growth and sustaining voter and business confidence.

The minor cuts in spending announced on 24 May (totalling £6.2 billion), to be followed by the June emergency budget and a spending review in the autumn of 2010, have only begun the process of cutting the annual deficit. Further spending cuts, possibly including more radical measures, can be expected following the autumn expenditure review.

There has also been a rapid move to change the system for monitoring the economic outlook, budget and public-sector spending. Two new bodies have been set up: an Office for Budget Responsibility (OBR) that will publish independent forecasts for the UK economy (on which budget planning will be based) and a ‘star chamber’ committee to subject public-sector services and finances to greater scrutiny. This should make the public sector more accountable and transparent, and should mean that mistakes such as those of the last few years are less likely or, at least, become a shared responsibility.

In terms of likely changes in taxation, carefully timed short-term ‘crisis taxes’ (such as increased VAT and higher-rate income tax) can be used as effective instruments to rapidly raise revenues and close the fiscal gap, with the government having the option to sweeten the pill by offering to review these crisis tax hikes as soon as the financial situation permits. Such a strategy would limit the need for immediate, substantial cuts (and job losses) in important areas of public-sector services and investment, while offering a positive stimulus to future growth. As emphasized above, the careful sequencing of actions should be part of any well-planned approach.

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14 Details are not known at the time of publication, but capital gains tax is expected to rise and there may be some form of bank tax announced, even though the G20 came to no agreement on this, leaving countries to decide for themselves. A VAT increase seems more likely in early 2011, which would coincide with the otherwise expected drop in inflation – a VAT rise may also be balanced by a reduced tax rate for low-income workers in line with coalition agreements.

15 The first, released on 14 June 2010 ahead of the interim budget, broadly confirms views expressed here that growth may soon recover to the 2–3% range and that public-sector finances are in need of sharp adjustment but are not in crisis.

16 Substantial changes would be better tackled as part of a long-term approach to the public-sector services and involvement in the economy, as envisaged as part of the ‘star chamber’ process and broader consultations.
In addition, private-sector initiatives can be encouraged to ‘crowd in’ and offset the impact of public-sector cuts – using incentives such as fast-track decision-making for project agreements, openness to FDI and belief in the government’s intent to maintain a business-friendly tax regime once the immediate fiscal crisis is over. The government may also get some help from the cyclical improvement in tax revenues that seems to be coming through this year. If this trend continues (and there is evidence that the UK’s tax take is strongly cyclical), then a revenue surge will ease the policy dilemma.

How quickly can deficit reduction be expected to proceed, and with what impact on both the debt/GDP ratio and economic growth? One approach to assessing the scope for fiscal austerity and debt reduction over the next few years, and its impact on economic prospects, is to compare the present situation with previous experience both in the UK and in other countries.

On this basis, confidence should be boosted by the fact that the UK and countries such as Sweden and Canada have demonstrated their ability to restore growth and sound public-sector finances after previous recessions. In particular, the current situation has marked similarities with that of the early 1990s, when budget deficits rose sharply during the recession but were subsequently reduced across a wide range of countries. This even occurred in countries with previously poor deficit records (5–10% of GDP) such as Ireland and Spain, which moved into surplus for a while, as well as Greece and Italy. Swings in budget deficits were generally large – on a par with what is required today – so clearly deficit reduction is achievable. The notable exception was Japan, which had a persistently large budget deficit (except in 2007) as tax revenues stalled while expenditure, including interest payments, rose. The additional stress of bank bailouts and a weakened banking system contributed to this failure, which has aroused concerns for the US and European countries this time round.

Setting aside Japan, there are two distinctions to be drawn from these comparisons. First, while most countries reduced their deficits in the late 1990s, only a few continued to consolidate public finances in the years just before the 2008–09 global crisis: the UK was more prudent than some but with hindsight not as prudent as it could have been (Figure 8). This left most countries, including Britain, poorly positioned to take on more debt during the recession. Secondly, a much greater proportion of the fiscal adjustment of Canada and the Scandinavian economies came from reducing expenditure, whereas the UK increased revenues as economic growth recovered (in part because its tax system is very strongly correlated with the economic cycle, for example through property and other financial transaction taxes). Britain may therefore

Figure 8: The UK’s government deficit in comparison to other countries (% of GDP)

Sources: EC, IMF, BEA
want to pay particular attention to the experience of these economies as the government is now seeking to put more emphasis on reviewing its overall spending.\(^\text{17}\)

Nevertheless, it is important to recognize that the UK itself made a successful transition in the 1990s. Over a five-year period from 1991–92, it turned around a large deficit (around 8% of GDP), achieving a balanced budget by 1998 (in fact the debt/GDP ratio had already started to fall by the time of the general election of 1997). This was helped by a return to economic growth and rising tax revenues, backed by a freeze on government spending and selective tax increases. This 1990s experience clearly resonates with today’s situation.

Past experience therefore provides a useful benchmark for what could be achieved over the next 5–10 years in terms of restoring growth and financial stability. True, there was a much sharper rise in the UK’s budget deficit during 2008–09 than in the early 1990s, but official estimates for deficit reductions from 2011 look remarkably similar to the pattern of cuts that was actually enacted from 1993. This 1990s experience clearly resonates with today’s situation.

Past experience therefore provides a useful benchmark for what could be achieved over the next 5–10 years in terms of restoring growth and financial stability. True, there was a much sharper rise in the UK’s budget deficit during 2008–09 than in the early 1990s, but official estimates for deficit reductions from 2011 look remarkably similar to the pattern of cuts that was actually enacted from 1993. This 1990s experience clearly resonates with today’s situation.

However, evidence from the period 1997–2001 also implies that the UK will have to generate a run of budget surpluses over the period 2015–19 in order to make a significant difference to the debt/GDP ratio. By 2001, debt/GDP was more than ten percentage points down from its peak in 1995–96; if this pattern of fiscal consolidation were to be repeated, debt/GDP might drop to below 80% by 2020. Asset sales (chiefly the stakes in the banks) could bring a further cut in debt, but the chances are that the UK’s debt/GDP ratio would remain considerably higher than the EU reference target of 60%. This illustrates just how tough it will be to return to a prudent level of debt over the course of the next decade.

Apart from providing evidence on debt adjustment, past recessions may also point to the potential for restoring economic growth at the same time as pursuing fiscal consolidation. After both the 1991 and 1981 recessions, the UK economy actually picked up strongly, with GDP rising by 3–4% in the first phase of recovery before settling back to its pre-crisis long-run trend in the 2.5–3% range. Thus, although the official

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\(^\text{17}\) Canada, Sweden and Finland all saw government expenditure decline by over 10% of GDP, while revenues remained more or less unchanged (as a share of GDP). In the UK, government expenditure declined only slightly (by 4.4% of GDP) and revenues increased by almost as much (3.3% of GDP).
forecasts (from HM Treasury) that underpinned the March budget were criticized as too optimistic, they were quite similar to previous post-recession experience. The first forecast from the new OBR (released on 14 June) has trimmed estimates for short-term growth but the trend is still envisaged to remain in the 2.5–3% range, broadly commensurate with the New Vigour scenario presented here.

In contrast, less optimistic projections\(^\text{18}\) point to the risk of a prolonged drag on growth similar to that experienced by Japan in its post-bubble 'lost decade', reflecting:

- the difficulties inherent in curbing the rise in public-sector debt and thus the possibility of much sharper budget cuts to come, leading to public-sector job losses, higher taxes, weaker domestic demand and a less buoyant economic recovery;

- the significant risk of policy mistakes, including errors in the timing and scale of adjustments as well as the policy mix – with errors more likely in view of the exceptional nature of the recent recession and policy decisions;

- the general degree of uncertainty about the global background and risks to the economic recovery, which include the aftermath of the Eurozone debt crisis: long-run growth for the developed world may not be sustained at its previous rate and even emerging markets could be at risk.

Given the concern over negative domestic impacts of fiscal constraints, the global outlook takes on even greater importance as a driver of UK growth. But this cannot be taken for granted.

The UK’s reliance on the global market

Over the next decade, UK growth will be unable to benefit as much as it did before the global financial crisis from domestic consumer spending, a housing market boom and bigger government. Both households and the government must curb borrowing,\(^\text{19}\) and the property market looks set for a period of slower development even though it has weathered the crisis better than many expected, in large part because of the UK’s persistently low rate of house-building.\(^\text{20}\) Thus exports – notably of business, professional and financial services, in which Britain has a strong comparative advantage,\(^\text{21}\) but also key manufactures (pharmaceuticals, food and drink, aircraft engines and other transport and hi-tech engineering) – will be a critical factor for generating future growth. The UK will also need to continue attracting substantial inward investment. FDI into London alone represents 25–30% of the city’s GDP, for example.\(^\text{22}\)

The combined business, professional and financial services sector is the largest industry in the UK economy (accounting for almost a third of GDP) and the force behind Britain’s standing as the world’s second largest services exporter and a major recipient of FDI. As much as 50–60% of the total expenditure growth in the UK economy over the last decade has come from domestic consumption of local services, while total exports and FDI have accounted for a further 30% of this expenditure growth.

The UK acts as a hub for many multinational companies requiring access to specialist professional services and a gateway to Europe. The hub effect has helped provide substantial investment inflows into London, generating above-average growth compared with the rest of the country.

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\(^{19}\) McKinsey Global Institute, *Debt and Deleveraging: The Global Credit Bubble and its Economic Consequences*, (January 2010), notes that debt levels in households and the financial sector are such that deleveraging must be expected. It also suggests that debt deleveraging typically lasts for seven years after a crisis.


This leads to three important questions that warrant the attention of policy-makers:

- How can the UK’s international offer and role as a commercial hub be improved, focusing on growth markets in order to boost the chances of a strong export performance, FDI inflows and thus an external economic stimulus?
- How can emerging economies be encouraged to open their markets to services as well as goods trade to the same degree as Europe and North America?
- How can a sufficiently equitable distribution of growth be ensured across the UK to complement growth in the London region and sustain the electorate’s support for an open economy? 23

Britain clearly has an interest in keeping global markets open, not only to help its own export efforts but also to promote the exports of the emerging powers: burgeoning world trade will foster the role of London as a global hub and encourage broader FDI inflows to Britain.

The global economy will matter even more to the UK in coming years than it has over the last decade. The rapidly rising emerging markets are a key target for export growth and also for attracting FDI and business growth into the country.

The UK must exercise as much influence as possible, therefore, over the global rules for trade and investment, pursuing its role as champion of the level playing field. There is an important opportunity here to build alliances – and business – through groups such as the G20.

But what are the prospects for global growth and what risks does this pose to the UK’s economic outlook?

Consensus forecasts predict that the global economy will regain and maintain its recent peak growth rate of 4–5% (in PPP terms). This relatively rosy outlook depends on the developing world continuing to expand steadily and rapidly (with China overtaking the US as the largest national economy in the world by around 2025, for example) while the advanced economies grow at average rates of just 1.5–2.5% as their populations stabilize and innovation and productivity growth become more difficult to achieve.

However, these forecasts ignore potential risks and instabilities in both the developed and developing world, most obviously in Europe but potentially within previously strong performers such as China and India as well.

23 This would go some way to addressing the complaints about the UK’s historical growth record and the danger of ignoring perceived inequalities. See for example Nick Crafts, Was the Thatcher Experiment Worth It? British Economic Growth in a European Context, Discussion Paper No. 710, Centre for Economic Policy Research (1992).
Weak growth prospects across most of Europe offer little opportunity for UK businesses to expand in the region, even though it currently accounts for 50–60% of UK exports. The impacts of fiscal adjustment and deleveraging on the EU may be made worse by a prolonged debt crisis involving a number of member states. This damage could limit growth in the advanced economies to the 1–2% range, damping down import demand. Weaker growth in world trade over the next decade would then have significant effects on the developing world. By 2012–13, for a variety of external and internal reasons (including migration of low-skill industries to even cheaper parts of Asia such as Cambodia and Laos, stalling export growth and falling investment rates), it may be increasingly difficult for China to sustain high growth in the 8–10% range, and the rate could slip to 6–8%. India is already vulnerable to the threat of internal inflation and overheating, and growth may fall to 5–6% instead of the hoped-for 8–9%. These faltering giants could drag down other developing economies and cut global growth. It is therefore quite plausible that the average growth rate for the developing world could drop back to the average of 4–6% seen in the 1990s, rather than staying at the elevated peak rates of 6–8% of the pre-crisis boom years. Consequently, global growth would drop to the 2–3% range and would almost certainly be more volatile as well (although this possibility is not depicted in the scenario chart in Figure 11).

A weaker global scenario would have an impact on the UK’s economic outlook, probably cutting future trend growth to about half the previous rate of 2–3%.

Under less favourable external assumptions, the UK would not only see its growth potential reduced; it would also struggle to improve its debt profile and avoid financial instability. London’s financial industry would suffer from the deterioration in Britain’s standing, further reducing the economy’s scope for growth and its financing capacity. How far this weakening in the UK’s position and brand image might go would depend on the severity of the global slowdown and on the government’s ability to manage the UK’s economy and public finances.

Could Britain exert an influence on global economic trends? Clearly, steering the world economy towards a sustainable growth path would be beneficial but this is hardly within the power of the UK economy to determine on its own. On the other hand, if the UK is successful in its own fiscal adjustments and adaptation to economic circumstances, it could act as an example and provide leadership to other countries, influencing them to follow suit. This might arguably improve the chances of a more favourable result for other economies, with spillover benefits for Britain. It would be an appropriate opportunity to demonstrate how international relations and influence might be used to create a more positive outcome.
Implications for the UK’s channels of influence

The manner of the UK’s exit from the economic crisis and the successful management of public finances over the next five years will have very significant long-term effects on the economy, on Britain’s relative position in the world and on its ability to persuade other countries to shape a global economy that grows robustly, to the UK’s advantage as well that of others. The UK’s international economic influence has depended not only on the size of its economy but on its relatively good growth record, its skills and flexibility in business and professional services as well as in manufacturing niches, and its success as a major commercial hub and global financial centre. The ability to say ‘do as we do’ has been heavily compromised by the global financial crisis, yet since the Thatcher era, this was a key element of the UK’s instruments of influence. It is important, therefore, to restore the economic conditions in which such a view is credible. Unless it has a visibly successful economy, Britain will fail to inspire confidence at home and abroad and will be unable to invest in instruments of influence and persuasion.

Aiming for future prosperity, enhancing the prospects of the New Vigour scenario, should be at the core of the policy package. At the same time, to ensure the UK’s economic security, adequate preparation needs to be made to meet future potential domestic or external threats to that security.

One immediate threat has been highlighted by the Eurozone debt crisis: the UK must avoid a similar credibility crisis and collapse in sterling. If this were to materialise, as envisaged in the weak fiscal management scenarios, A Lost Decade and Fiscal Failure, it could be far worse than the sterling crisis of the late 1970s. It would not only destabilize the economy in the short term but also cause severe long-term restrictions on the ability of the state to sustain the infrastructure (physical, human and societal) that makes the UK an attractive place in which to live, do business and invest. It is essential, therefore, that policy-makers not only rigorously address the short-term risks but also, in their policy choices, look beyond the next few years’ budgets to wider issues and the longer run. An explicit growth strategy based on a raft of innovation- and skill-building exercises, key infrastructure initiatives and market-sensitive regulatory reform, operating alongside the urgent fiscal consolidation programme, would help instil vital long-term purpose and strategic thinking to the policy agenda. This follows the path already recommended for fiscal policy: implement the necessary near-term cuts in the budget but explain how policy will evolve differently as economic growth and fiscal health are restored.

A more subtle threat to the UK economy is the impact of changing international economic relations. In this case, the government should be bold in seeking to sustain the UK’s status in the premier rank of the world’s most important and competitive economies.

Confidence-building and thought leadership can also support and protect the UK economy. For example, the international standing of both Britain and London play a key role in fostering the business sectors in which the UK specializes and has international comparative advantages. It is critical to be, and be seen as, a successful economy with strong domestic finances and influence in the world. To thrive over the next decade, the UK must develop and attract the investment, the deep pool of talent and the critical industry clusters necessary to sustain creativity, innovation and a vibrant business base.

24 Transport and energy are seen as critical. For example, Ofgem (the energy regulator) has recently suggested that £200bn of proposed investment must be brought forward (Financial Times, 3 February 2010).
25 Sectors identified by the BIS as UK strengths include life sciences, professional services, insurance and creative industries.
However, this is not just a matter of domestic choices. It requires the appropriate external environment and global governance. Hence, a more subtle threat to the UK economy is the impact of changing international economic relations. In this case, the government should be bold in seeking to sustain the UK’s status in the premier rank of the world’s most important and competitive economies.

The financial crisis galvanized the UK into becoming a central protagonist in coordinating the global response within the G20. Notably, it provided strong leadership at the critical juncture of the US presidential handover. This skill remains an essential element in the UK’s policy instruments.

An immediate example of the need to seek ways to mould future events is the prospect of global financial regulation and reform, which will affect the UK’s interests at a time when its credibility in guiding such change has been weakened. The recent German unilateral decision to ban naked short selling – irrespective of its merits – demonstrates how easily international cooperation can unravel. It also illustrates that such regulation matters in different ways for some economies than others – perspectives vary widely and the UK must have the opportunity to voice its view and challenge others.

While the UK will continue to have to negotiate and jostle with its EU partners in developing effective new EU rules and oversight procedures for EU financial markets, over the long run the trend towards a rebalancing of the international economic order in favour of the developing world is irreversible. As a result, the global financial crisis has intensified demands for increased representation of developing countries in the global economic institutions. This has consequences for the UK’s international position. The focus has to be on maintaining important channels of influence, while becoming a more active player in those areas most integrated with Britain’s external interests.

The demise of the G7/8 and its effective replacement by the G20 in the area of international economic cooperation is one symptom of this development. At a minimum this dilutes Britain’s global influence. At worst, the UK risks being excluded altogether from the very top economic table, with the possible exception of financial market meetings – and even that invitation would be contingent on the future of London as a global financial centre. In addition, over-represented Europe is under pressure in the IMF from developing Asia and Latin America, which are demanding greater voting power and influence. This is likely to raise discussion over reducing the number of individual EU country seats on the IMF Executive Board and EU voting weight in the IMF overall. EU members may accept a diminution of their national votes in the IMF (which are spread across a number of constituencies) while still potentially increasing their collective influence. Under some scenarios an EU27 constituency might even have a veto on the Executive Board, just like the US. However, if Eurozone members looked to combine into a single constituency in the IMF, the UK could be left as the largest EU member outside such a constituency, and with little or no claim to leadership of the remaining EU members.

It is an open question whether the outbreak of the Eurozone debt crisis, and especially the involvement of the IMF, might speed up this process or slow it down. New arrangements and operational mechanisms within the Eurozone will not become clear until it has resolved its crisis one way or another. Under any circumstances, however, it is difficult to imagine any political appetite in Britain to contemplate a further pooling of economic policy sovereignty. The European Commission’s Eurobarometer survey of public opinion across the EU suggests that voters in Britain continue to be among the most mistrustful of European institutions.

Nevertheless, responsibility for trade and overseas investment policy is already vested in the European Commission (albeit subject to the oversight of the Council of Ministers and the European Parliament), including for the all-important trade in business and professional services. Furthermore, the EU is seeking to raise its profile in traditional diplomacy following the ratification of the Lisbon Treaty. The UK needs to recognize

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that macro-economic policy and financial supervision may not be immune to this trend towards greater EU coordination. If the Eurozone is strengthened and its fundamental problems start to be resolved, it could be seen as a more powerful and attractive partner in international economic relations. Unless it is then prepared to engage in a more proactive EU approach towards the management of domestic and international economic issues, the UK might be left drifting with declining influence at the global and European level.

The dilemma for the UK is clear in the alternative scenarios outlined for its economic outlook. Under strong growth scenarios, such as New Vigour, Britain may be able to return comfortably to ‘business as usual’ both in domestic economic terms and in terms of its economic relations with its EU partners and others for many years to come. It would be well placed to build new partnerships in the fast-growing developing world, reflecting both common business interests and engagement in the G20. However, weaker growth scenarios for both the UK and the global economy would signal a change in policy choices that would almost certainly include harsh public spending cuts affecting both the domestic economy and external objectives. The government would then need to consider how to strengthen its economic relationships with its ‘old partners’, especially in the EU, in order to manage more effectively its unfavourable position in the global economic environment.

Conclusions: securing a more stable and prosperous future

The extent of Britain’s success or failure in managing fiscal adjustment and its impact on the economic recovery will not be clear for some time. The new government is prepared to be tough: the coalition agreement reflects broad acceptance of the urgency of the need to tackle the deficit now in view of the rising threat level in the international markets on which the UK depends. It remains to be seen, however, whether the new Chancellor can craft policies to match the immediate demand for tough action while maintaining a vision for a better future, keeping the door open for a possible relaxation of austerity if the fiscal position does improve over the next couple of years. In spite of the need for deficit reduction, it would be a mistake to lose sight of the real goal of long-term sustainable economic growth and prosperity.

One of the overall conclusions that can be drawn from this analysis is that the greater the uncertainty about the global outlook, the risk of debt crises erupting and potential financial market turbulence, the more important it is that Britain rapidly and competently improves its own public-sector finances. This will reduce the immediate threat of contagion for the UK and also bolster confidence in a more secure and stable outlook for the nation’s economic wellbeing and in the potential for rising prosperity.

Countries with weakened public-sector finances can ill afford to face any new downturn or risk. However, it is all too probable that there will be a dip or disruption in global growth at some time over the next decade – even if short-term growth remains reasonably robust and long-term trends are favourable, accidents happen. In this case, the ability of countries to respond (as they did in 2008–09) could be dangerously impaired. The possibility of future turbulence is too high to ignore and the prudent strategy must be to rein in debt sooner rather than later in order to be better prepared for any future contingencies. Without doubt, policymakers will work to ensure a favourable outcome, but they must also have a carefully considered emergency plan (and scope for action) in case less favourable scenarios emerge.

The test will be to make the right moves now to safeguard Britain from risks such as contagion or global turbulence, while inspiring confidence in the potential for a return to vigorous growth. Austerity does not deliver the latter although it is a necessary part of the response to imminent threats to the UK’s economic security. Ultimately, growth will be based on maintaining a dynamic, flexible economy open to ever-changing global opportunities and relationships, new industries and new ways of organizing economic activity. The fiscal debate should not be allowed to obscure this.

28 It may seem to be stating the obvious but clearly the Eurozone has failed this ‘contingency plan’ test, being caught out by the Greek debt crisis.
Aiming for New Vigour: The UK in the Global Economy

Rethinking the UK’s International Ambitions and Choices

This major Chatham House project is assessing the UK’s international priorities and the policy choices it faces in matching its interests, ambitions and resources. It is led by Dr Robin Niblett, Director, with the support of Alex Vines OBE, Research Director, Regional and Security Studies, and Dr Paul Cornish, Carrington Professor of International Security and Head of the International Security Programme.

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