Type of paper: Transcript

Aiming for New Vigour: The UK in the Global Economy

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Monday 19 July 2010
AIMING FOR NEW VIGOUR: THE UK IN THE GLOBAL ECONOMY

Introduction: Dr Robin Niblett, Director, Chatham House

As I think you all know, this is part of a project that we’ve been running here for the last six to seven months looking at various aspects of Britain’s role in the world and we were always going to have a paper on Britain and where it sits within the global economy but I think what’s become apparent both through the opening paper and as we’ve gone on with the project is just how central the health of Britain’s economy and where it sits relative to other countries is going to be for the future prosperity and security of the country more broadly.

To state the obvious, we all know money is tight and it’s going to affect what we’re able to do but I think there are some particular strengths we can play to but as we’ve had in our various discussions briefing this paper to people in government and outside it’s going to be a tough job and maybe the two speakers will have a chance to talk about this.

So we’ve got our two paper authors with us here and I’ll ask them in a minute just to give ten minutes each maybe of some of their key insights and then we’re delighted to have Jo Johnson with us who, as I think most of you know has just become a member of parliament at the most recent election so congratulations for winning that election victory but somebody who’s been Associate Editor at the Financial Times prior to taking his position as Editor of the Lex Column, continues to be a contributing Editor to the Financial Times right now and somebody who therefore is well placed to understand the UK’s role in the global economy in particular having worked on South Asia, so therefore part of that new world that the British economy is trying to tap into.

Jim and Vanessa I think are known to most of you as members of Chatham House. Vanessa Rossi is a Senior Fellow here at Chatham House having joined us from Oxford Economics, somebody who’s been a top analyst on the global economy I would say and as she herself would probably say more than on the British economy in the past in recent years but put her in a particularly interesting position therefore to do comparative work. She’s worked in the City, provided advisory work to the European Commission and other groups as well.

So Vanessa will kick off and then she’ll be followed by Jim Rollo who is an Associate Fellow of the International Economics area at Chatham House; was once the director of the International Economics Programme at Chatham House but is currently Professor for European economic integration at the
University of Sussex and also the co-director of the Sussex European Institute but he has worked as the senior economic adviser to the FCO, has worked in the Treasury, has government experience therefore as well as having worked as an academic analyst and interpreter of what the government is up to and whether it should or shouldn’t be.

**Vanessa Rossi:**

When we first started out this project in the Spring I was thinking through what types of views, themes, we might develop and of course at this time in the midst of an election I think more of what we were hearing was about uncertainties, risks and possibly a pretty gloomy looking economic scenario for the UK.

Certainly if we listen to that agenda most of which was relating to the internal discussions – domestic economy, how bad fiscal cuts would be - and it seemed certainly in many of the public’s views to come down to local services, how many hospital beds as defining factors in this whole policy in the economic outlook, it seemed to us that perhaps there was an insufficient attention being paid to the international scene and to how both the UK is viewed from abroad and what its influence is in turn abroad and how did this relate to the UK’s potential economic outlook and we certainly thought that there was a potential to be far less gloomy than many of these other prognoses would have us be.

It struck me in the last week - we had a couple of days worth of conferences on the UK in the world economy that was discussing many different facets of this; UK in the world rather more generally, not just the economic side – many different facets of this and we still saw this range of views coming through with many peoples economic instincts about the UK still very much being dominated by this problem of the fiscal agenda and the local issues and not getting away to what I would say is a broader picture.

So I think we have to recall that the view of the UK from abroad is somewhat differently coloured particularly in this fiscal issue by the fact that given the potential risks for sovereign debt around the world – a number of countries now seeing rising debt and of course already the outbreak of crises in countries such as Greece, arguably in some of the other European countries too – the need to put the fiscal house in order became imperative and from the point of view of the rest of the world the UK is seen as doing the right things broadly speaking; that this is a necessary action to cut back on the
high deficit and that overall there's a quite high degree of confidence that the UK can successfully do this.

So when we started putting forward these views about the UK, after the tone was taken from these views together with the analysis of how well relatively speaking the UK's done from growth abroad over the years, not just in the manufacturers trade but actually in exceptionally strong position in services trade, revealed comparative advantage in services trade worldwide which is after all one of the higher growth segments of world trade, we've done quite well.

So we were coloured by these factors into taking a rather more optimistic view and I thought at first that we might meet resistance to this given perhaps what seemed to be more of a view on the ground that there was pessimism about the UK's prospects. So I was quite heartened that even when we started early discussions with panels of experts a number of people were very encouraging about this view and actually felt that what we were doing was far less biased and was taking a more open perspective on what we can do about it.

So I think that in terms of putting these debates together I also turned to trying to stylise these thoughts in a sort of scenario approach which you can see pictured on Page 8 of this report and this partly is an antidote to what I felt was a too economist technical view of how alternative scenarios were being put forward – nothing wrong with that from the Bank of England and the Treasury and so forth. These big flow diagrams that show ever increasing divergences and probabilities of whether we were going to grow at an average of 2.1 or 2.6 or 3.5 or whatever and probabilities attached to this. I mean as an econometrician and forecaster of some years I quite understand all those things, I understand what they're doing, but I don't think it's very explanatory to the public of what actually are the processes pushing us towards different growth scenarios, towards different outcomes of these games and I felt perhaps it was more sensible to take the approach I've taken here in explaining why it is we could see growth moving higher or lower rather than telling you that I have a 10% probability attached to a figure of 3.7 and of course this spread has widened out so effectively some of these forecasters are now telling us that growth could be anywhere between 0 and 6%. I don't find that terribly useful I suppose, as apart from being a technical exercise.

So I think this approach of trying to be explanatory about what we're seeing happening will help. It not only puts some numbers on this, whether we think we could achieve the higher growth scenarios of 2½ , 3, 3½% or whether we
end up with a prolonged recession, whether we see one of these styles or other is going to be determined by effectively these two big drivers of the economy for the forthcoming years. And this picture is not just relevant to the UK. It’s relevant to many other countries in the context of the rising debt across the developed world as a response to recession and the fact that we all of us seem to be depending ever more on the rest of the world’s growth and the world trade growth to pull our economies along.

So we see these two important driving factors for the UK and particularly this emphasis, as Robin’s put it as well on the world growth, is that if we actually can achieve this higher world growth scenario then even we can overcome whether or not the nuances of the UK’s fiscal policy is quite right or not, it’s a very difficult call to get those nuances quite right but that with a strong global growth situation we can actually see the UK pulling through these problems and turning around.

It then of course becomes a problem of what we can do about external growth and unfortunately it sort of flops back in some people’s view about well it’s there or it isn’t and we can’t do much about it and we would argue of course that that’s not true. There are many things we can do about it both in terms of identifying where we believe the UK can achieve growth and trying to pinpoint that and do more about promoting those sectors and also even the UK’s ability to steer some of the things that go on in the world economy. We shouldn’t think of ourselves as negligible in that equation. There are many ways in which we can take positions by both bilaterally and in the discussions for example at the G20 in which we have opportunities to influence the outcome and it’s clear that the UK has been a long-term advocate of open economies, open trade, open market and I think that clearly plays well with a number of these other partners but also that this is extremely important to the benefits for the UK economy.

Again I come back to this argument that in terms of our trade performance over the last decade we can roughly breakdown the overall growth in expenditure in the UK economy to being a third of it from the external sector, most of which has come from services exports – don’t let’s fool ourselves with that – and out of the remaining part, a large part of that has also come from FDI. If we add together both the services sector and the FDI component this far outweighs the overall gains that we’ve seen in manufacturing trade.

Foreign Direct Investment into the UK. Investment particularly in London accounts for around a third of the overall economy here, a very important element, but of course the benefits of that spread out around the rest of the
country. You may not be able to export to India from Banbury or from Newcastle on Tyne but you can do it in terms of selling to London that can sell on to these countries as well.

The importance of those chains of growth needs to be fostered and certainly in terms of the benefits we’ve seen, as I say about a third of our overall growth has come from this. Around a third out of the rest of the growth; another third has come from the growth in domestic demand from services and around a third from domestic demand for other goods part of which of course come as imports from abroad. So there’s an important element here of growth.

With fiscal austerity undoubtedly we have to tighten the belts, reduce down these problems of the increasing debt in the public sector accounts. Because of that and because of the impact it may have on reducing down domestic demand it’s even more important that we succeed in gaining and keeping that share of growth that’s coming from the export side. If we’re looking forward, if roughly one percentage point each of growth had come from these three factors we need to keep the 1% of growth as coming from the external side as even if we lose from 2% to 1% from the internal side we’re still looking at a growth scenario for the UK economy of perhaps just over 2% a year which wouldn’t be bad in these circumstances. It would give us enough growth to start pulling away from the debt problem as well, even levelling the problem of how much the public sector accounts have squeezed the per capita have to help to achieve that. So important we get there.

In terms of fostering this growth then, what can we do about it? Well we said we need to talk to other partners. At the G20 we should remember this isn’t just dialogue with the US, it’s not just dialogue with European partners – we can do that at lots of other events as well – we need to be engaging with other people in that forum. It isn’t just India and China either. We should remember other large economies there such as, for example, Indonesia. It reminds me because there’s just been a Lord Mayor’s visit recently and I’m writing a report on this issue of Indonesia and it’s an economy that’s quite important and often forgotten. So there’s a number of players there which will also be interested in the same issues as the UK – opening up of markets, opening of trade, opening of finance will be a good theme to pursue.

It’s also in terms of this foreign direct investment in the UK essential to help supplement what meagre funds we’re going to have for investment in the next few years. Investments are very important to maintain because otherwise if we don’t we’re actually damaging the longer term future. So if we have to cut
back in other ways during the next few years to meet the public finances problem we don’t want it to be at the expense of investment in the economy and future infrastructure and the future dynamics of the economy.

To help offset that trying to encourage foreign direct investment will be important and in that context of course an important new partner is China. This is an area in which we’re seeing growing inward investment and generally growing flows of funds going abroad from China as part of the overall savings that flow out of China. So the UK can be more proactive in some of these areas too.

So I think we need to look not only at these key features of how the economy’s functioning, the importance of the external side and we should look more at that and less at these domestic arguments but also at these particular routes by which we can help to ensure that we leverage as much as possible of that external growth.

Professor Jim Rollo:

Let me first of all say I have actually never worked in the Treasury. An awful lot of people think I have at some point or another including Treasury civil servants, which I don’t know whether to take as a compliment or not – it’s a sort of interesting question in Whitehall etiquette, perhaps it’s just me being another member of the dismal science that makes people think that – but I have worked in the Treasury building which may have fooled you alongside Nicholas Bain who I see at the back there when the Foreign Office had an outpost in that building. But that’s not to say that I’m not actually very sympathetic to the situation that British economic policy finds itself in at the moment and I want to talk a little bit about that. Vanessa’s said most of the things I think that need saying but let me underline a few of them.

I think the first one to say is that foreign policy and foreign economic policy and the effectiveness of is made at home, it’s not made overseas; so if we want to be influential in the world we need to be relatively and reasonably successful. We can’t grow like China – that’s an impossibility – but we have to maximise our underlying rate of growth it seems to me otherwise people won’t want to talk to us and why would we? I’m scarred by the 1970s working in Whitehall when no-one in the rest of the world paid any attention to what we said. It didn’t matter how many advantages we had in various international institutions – members of the G7 or G8, or G7 it was at that time, even G5 – or a very important member of the IMF management board or whatever. None of that really mattered. What mattered was when the
performance of the British economy started to change and we showed a freshness in approach. Now I didn’t necessarily approve of everything that was done in the early ‘80s at the time and in retrospect I do think some of them could be done differently with similar effects and fewer costs but nonetheless it was an immensely important change of style and approach and it had some quick wins, relatively quick wins, that gave us a place in the world that we didn’t have before and people started listening to us. And I think that’s what’s important and that’s what’s important about the new vigour scenario here. I think it’s helpful to think, from less than purely technical terms, to think in terms of these scenarios. They’re broad-brush but they give you a sense of what has to be right for us in all of this and you will note in it that the state of the world economy is important in taking us at least out of the middle range of scenarios into the top end scenario. If we go to the bottom end scenario that would definitely be us to blame it seems to me, so that’s in our own hands.

Of course if we are dependent on world growth, the openness of world markets – a point that Robin makes in his overarching report on this bigger project of the UK in the world – then that’s a key point that we need to try and influence the world to keep the markets open and to do things that are broadly in our interests.

Now we do this against a background which is in many ways wonderful in global terms. The growth that’s going on in China and India, in other parts of East Asia and South-East Asia, in Latin America - some people may suffer from this but in my view it’s pretty nearly an unqualified good thing for the rest of the world to start catching up with us is surely one of the things we should want for it.

So we are going to be in relative decline. We always have been in relative decline since Germany and America came on the scene in the late 19th Century so that’s not a new story but we are facing rates of growth we have not seen in very large economies in a way that we haven’t quite seen before, not even Japan I think in this context. So we’re under a lot more pressure in terms of our positioning in the institutions that manage the world economy and whether that’s a demise de facto of the G7 as an economic policy-making format or policy coordination format and the move to the G20 and yet at the very least the G20 must dilute our power to influence which is more people we need to deal with with different perspectives on things and different interests.
At the other end you may well think, and I sometimes do, that the G20 is more of a disguise for a re-concentration of the global management into a new G2, G3, G4 but one which may include the eurozone but will not probably include the UK at that level.

So if we are going to be influential at a global level against that sort of long-term background we need to both be leaders in some areas – we may not be leaders across the board, our underlying growth rate is unlikely to exceed 3% certainly per capita (unclear) and that would be a maximum I would have said on average that we could reach – but over 2, as Vanessa says, would leave us in a relatively much stronger position but I think within that we would need to have some real leaders and that could be financial services, it could be other services, it could be elements of manufacturing where we lead. After all manufacturing is not weak in this country. It’s a strong sector, it’s a big trading sector and it’s got an advantage coming to it from the exchange rate currently which we hope will invigorate that. It could be from the cultural side. We talk widely – and I’m in a university now so I must talk up my own book in this context - for leadership though my own view of thought leadership is that thought has to be followed pretty quickly by successful action for anyone to pay any attention to it so that we’ve got institutions and we’ve got people that can put us in that leading position.

Nonetheless over the long-term we are going to have to make some quite difficult strategic choices. As the number of important players increases we have to maximise our bilateral contacts with those. So it’s a sort of jigsaw of relationships with different people. At the same time we may have to think that we need some very big strategic partners in this and this obviously harps back to an argument about EU membership - I know it wasn’t EU then but let me just use that label – in the ‘60s and indeed in the ‘70s about why we were there and what it was about and about leveraging our position and so on through a bigger group and that will depend on us making some quite big strategic trade-offs. There may be some things that we have to sacrifice in the short-term. There may be plenty of people in this country who now think we ought to sacrifice the financial services sector. There’s certainly quite a strong intellectual thread going on that the financial sector has not added greatly to British value added and that much of the growth that we saw in the last ten years through the financial sector was not a good thing. There are all sorts of possibilities out there that could shift but if we go down that route we have to find something else to put in its place.

Of course the obvious candidate for this is the EU in this context and that may provide particular problems for this government but I don’t think that challenge
will go away whoever’s in power. We do need to think what is it we’re willing to give up, what is it we want in return.

**Jo Johnson MP:**

A great paper. It’s had a tremendous impact in Westminster following your presentation of it a few weeks ago and I just wanted to say that I couldn’t agree more with the overriding thrust of it, namely that the outlook for UK growth is going to be driven by two things, first our ability to hitch a ride on growth overseas and particularly in the fastest growing emerging markets, India and China and the second proposition that hinges on the coalition government’s ability to, as you say, get the nuances of fiscal austerity right, to recognise that our public finances are in an unsustainable condition but not to be so hasty that we push ourselves back into recession. Those are the two planks and I absolutely agree with that.

Taking the second part of your argument first because I’m going to just say a couple of things about it before spending more time on the global growth side of it: I think it’s worth remembering that recoveries out of recession always feel fragile and this one was always going to feel fragile just because the recession was so much steeper than we have recently seen and the recovery out of recession has been heightened by the sovereign balance sheet crises in continental Europe. Similarly, just as in every recession there’s always talk of depression, so in every recovery there’s always talk of the risk of a double dip. So recoveries are fragile things by their very nature and I don’t think that we should get too alarmed at the tightrope that we’re having to navigate.

In general I think the debate between cutters – i.e. Tories, and postponers – i.e. everyone else, has had a lot of air play in recent weeks and months and I don’t think there’s much point in dwelling too much longer on it.

Turning to the question about how Britain can best go about leveraging global growth, I think the first thing to say is the good news is there’s a lot more global growth around than we thought until recently. In April 2009 at the time of that very significant London G20 summit the consensus forecast for global growth was 1.9%. By September last year that had risen to 2.6% and last month consensus forecasts for global growth in 2010 had reached 3.5%. Now a very large chunk of this global growth, as Vanessa and Jim have said, is being driven by emerging markets overseas and we’ve got to make sure that we’re hitching the UK economy to that growth.
I thought it might be interesting to say a few words about one specific aspect of the government’s foreign economic policy in which I as a humble back-bencher have been allowed to assist with and that’s with respect to India. As you will all know David Cameron, George Osborne, Vince Cable, William Hague, David Willetts and Jeremy Hunt and a host of other cabinet ministers will next Monday be carpet bombing India – literally. It’s a diplomatic or governmental delegation that is absolutely unprecedented in size and it’s also very significant coming so early on in the life of a government and there’s a clear indication of the government intent to make sure that we really get India as a country and that we do everything that we can to deepen and strengthen our economic ties.

It’s also worth noting that the Queen’s Speech for example gave India the very rare distinction of singling out the bilateral UK-India relationship as being of a special importance to this government going forward. The term was used ‘the new special relationship’. Now David Cameron by instinct is very wary of the Heseltinean tradition of herding businessmen on to aeroplanes in the hope of drumming up business and steering bilateral economic relations in certain directions but the fact is that there is an acceleration in the shift of global economic and political power from west to east and the government doesn’t really see much alternative but to get on those aeroplanes and to start using ministerial presence as a battering ram for our businesses. George Osborne will personally be taking business people in to see leading Indian business people. David Cameron will be doing the same in Bangalore. There is a strong determination to do whatever the government can to open doors for business while they’re there.

And when you look at the UK-India relationship which happened over the last 10/15 years, most of which happening to coincide with a period of Labour administration, you do see a strong sense of drift and decline I’m afraid. The UK has been losing share of trade in India, it’s been losing share in foreign direct investment and more worryingly perhaps it’s also been losing share of mind. In a decade the UK’s gone from being India’s fourth most important source of imports to being the eighteenth largest last year. The UK is still the fourth largest cumulative source of foreign direct investment into India with a stock of 8.3 billion invested there but such influence has been declining in each of the last five years.

On the share of mind front, it’s very clear to me, having spent four years there recently up until 2008, that the UK’s psychological importance in the Indian mindset is certainly diminishing. I think Britishness is a currency of depreciating value there. There is still a generation of Indian leaders, the
Montek Singh Ahluwalias, the Manmohan Singh’s who are Oxford or Cambridge educated who still pay a close attention to what’s going on in the UK but the generation that’s coming up in a country where the average age is under 25 you know frankly the British are about as relevant as the Moguls and there is really not much cultural resonance anymore and Britain would be making a grave mistake if it thought that it could rely on its ties of culture and history to sustain its relevance. I really don’t think that would be wise in any way.

There are still a lot of things that Cameron and Osborne and Co can play with. The relationship is still in many ways very very strong. The UK is the preferred launch pad for Indian companies seeking to access the European market. There are more Indian companies headquartered in the UK than in any other country anywhere in the world outside of India. People to people ties are tremendously strong. The wealth generating Indian class loves summering here – [unclear] to Delhi is here in June - and London is the preferred place for the affluent Indian class to buy their first home outside of India.

All that won’t change and isn’t really under threat. Similarly the educated in Britain brand is very very strong. There are presently more Indian students studying here, 34,000, than there have been at any time in our histories but there is a quality issue. There are not very many Indians studying at the elite Russell Group universities; in fact there are ten times as many Chinese at these top universities and there is I’m afraid a sense in India that if you really want to get ahead in life you don’t go to a British university, you go off to an Ivy League one.

I think the underlying problem which David Cameron and George Osborne and Co are going to confront and in fact they know about it already is that it’s very difficult for the UK to differentiate itself in its conversations with their counterparts in Delhi from dozens of other mid-sized European countries seeking a strategic relationship with India and I think what they’re also finding is that such leverage as the UK does have with Delhi is not really often used to very good effect. The relationship in some ways has been a sort of a paradigm in how not to do it. I think we’ve got a very very fragmented way of representing ourselves diplomatically and commercially overseas, certainly at least in India, and our poorly integrated cross-departmental approach to policy also leaves our counterparts very confused.

So I think one of the things that David Cameron and George Osborne and Co should seriously think about doing is getting someone to get a grip on the UK-
India relationship, possibly in the form of a special envoy and with a more political background, someone who can bang heads together, someone who can stop UKTI and the UK-India Business Council working at cross-purposes, someone who can stop DFID working a cross-purposes with the Foreign Office, someone who can just basically get a grip on a bewildering proliferation of initiatives across quango land and Whitehall. I think the ideal person from that point of view would be someone like Richard Lambert, shortly to leave the Confederation of British Industry, a real figure of stature in the business world who could help British business people achieve a lot of their objectives there.

I think, just going to one of the points Vanessa was making about where are we strong as an economy overseas - we export financial services largely – we can’t do it unless people open up their markets and we’ve been very ineffective at persuading India to open up the sectors of its economy that we are most competitive in. Retail is shut to multi brand retailers in the FDI channel. Financial services are pretty much a closed book. Insurance is capped at 26%. And one of the excellent points you make in your paper is that the financial crisis has done immense damage to our reputational capital. One of the points you make is that there’s a very high government and regulatory content to our exports and a confidence in our ability to be good social citizens is not at its highest right now.

I remember when I was in Delhi once the US Treasury Secretary, John Snow came through with the Chief Executive of AIG, the American insurer that blew up half the American financial system with its structured products – and this was in about 2007 I think – and they gave the assembled audience of business people the most tremendous lecture about how they were stifling economic growth in India by not allowing American style insurance practises to open up their markets and I think the financial crisis has reinforced what was already a very protectionist mindset in India but it’s also more importantly given it an ideological coherence that it didn’t really have before to the conservatism of the Reserve Bank of India. So the prospects of us being able to achieve a lot of our market access goals, particularly in financial services, has taken a big knock. Banks will find it increasingly difficult to open up the branches across India that they’ve been wanting to do for example.

I think the stark truth is that unlike the US, which in 2008 managed to deliver a big game changer in its bilateral relations by opening up civil nuclear trade and civil nuclear material with India, the UK’s got nothing that it can offer; it’s got no single transformational deal that will really get the Indian elite’s attention. Britain can repeat all it likes that it wants India to join the Security
Council on a permanent basis, it can offer to reform the governance of the IMF but in neither case does Britain have the power to do anything about it on its own. It’s very much dependent on other people and on international coordination.

Similarly, one of the key policy objectives for Delhi is the signature of an EU-India FTA agreement, free trade agreement in the absence of a bigger deal in Doha but again, David Cameron and George Osborne have precious little that they can do on that front on their own bat.

So it’s all very well to talk about leveraging our global influence but when you actually get down to it it’s very very difficult to do. We can call all we like for a new special relationship but it’s very difficult indeed to actually achieve one. That said, it won’t be for lacking of trying.