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ideas for economic growth

Basic economics suggests that a country which imports more than it exports will also see the value of its currency decline. Yet during the 2000s, the UK incurred a cumulative trade deficit of over half a trillion dollars while sterling's position on the foreign exchange markets was extraordinarily strong. This was only possible because of high inward investment into the UK over this period, which saw many British companies and assets sold to foreign buyers while doing little to improve the UK's production capacity. Vast swathes of the British economy, from power companies to merchant banks, are no longer domestically controlled. Britain has been unique in this lax approach to control of key national assets, which has created major problems. Not only has it sometimes led to reduced investment in purchased companies, as foreign purchasers prioritise their home markets, but it kept sterling far too strong. The latter has had a crippling effect on the UK's competitiveness and our ability to pay our way in the world. Policy makers should heed the lessons of the 2000s as a warning for the future.

Why was the exchange rate so high during much of the 2000s?

John Mills

During the first decade of the twenty first century sterling's position on the foreign exchange markets was extraordinarily strong. During the whole of the period from 2000 to 2008, the value of sterling against the dollar climbed slowly from about $1.50 in 2000 to a peak of just over $2.00, which it averaged for the whole of 2007. It then fell abruptly but very briefly in 2008 to just below $1.40 before stabilising for the last three years at around $1.60.[1] Against the euro over the same period, the highest yearly average was €1.64 in 2000, with a slow climb to this peak followed by a gentle and then more rapid decline, bottoming briefly at €1.02 before climbing back to its current €1.25.[2] The strength of sterling against the dollar and the euro was not, however, a reflection on the UK's trading record during this period, which was of large and continuous current account deficits. In not one single year between 2000 and 2010 was there a surplus.

The deficits fluctuated between $28bn in 2002 and $82bn in 2006. During the whole of the period between 2000 and 2010, the cumulative deficit was just under $520bn, as can be seen from the figures laid out on Table 1. How was it possible for the sterling exchange rate to be so strong when the balance of payments performance on the current account was so weak? Part of the reason is that the current account was buttressed by substantial net

income from abroad – $409bn over the ten year period. Even taking this into account, however, there was still a cumulative deficit of over half a trillion dollars. Without the net income, this figure would have been almost a trillion dollars, composed of a $706bn deficit in goods and services and another $223bn in net transfers abroad, mostly on aid programmes and net payments to the European Union. How could sterling have been as strong as it was against the background of such a chronically poor trading performance, leading to such persistent large payments deficits on the current account?

Table 1:
UK Current Account 2000-2010

All figures in billions of US Dollars

Year	Goods and Services Trade Balance	Income Balance	Transfers Balance	Net Overall
2000	-29.20	5.16	-14.76	-38.80
2001	-38.50	17.60	-9.37	-30.27
2002	-46.48	31.89	-13.26	-27.85
2003	-48.08	34.09	-16.00	-29.99
2004	-63.66	37.06	-18.82	-45.42
2005	-79.88	42.11	-21.63	-59.40
2006	-79.70	19.56	-21.82	-81.96
2007	-94.21	50.25	-27.11	-71.07
2008	-89.31	74.64	-26.49	-41.16
2009	-54.93	40.66	-22.79	-37.06
2010	-81.94	56.28	-30.52	-56.18
Totals	**-705.89**	**409.30**	**-222.57**	**-519.16**

Source: Page 743 in International Financial Statistics. Washington DC: IMF, 2011.

It appears that the explanation for this paradox lies in another set of figures which are set out on Table 2. These show two different data sets on inward and outward portfolio investment for the UK for the same decade from 2000 to 2010. One set of figures – in dollars – comes from the International Monetary Fund (IMF) and the other – in sterling – from the British Office of National Statistics (ONS). The values year by year are not the same, no doubt because they were compiled in rather different ways. The overall trend of both sets of figures, however, is clear. In almost every year, the sale of British portfolio assets to foreign buyers hugely exceeded British purchases of foreign portfolio assets. Cumulatively over the period 2000 to 2010 net sales of UK portfolio assets came to $700bn according to the IMF and to £615bn using the ONS figures. This massive inflow of funds must have been a major factor in keeping the exchange rate as high as it was. It is no coincidence that when the net sales diminished at the end of the decade, the exchange rate fell – from about $2.00 in 2007 to $1.60 in 2009.

Table 2:
Inward and Outward Portfolio Investment in the UK 2000 – 2010

Billions of US Dollars

Year	Inward Portfolio Investment	Outward Portfolio Investment	Net Inward Portfolio Investment
2000	268.10	97.19	170.91
2001	59.06	124.73	-65.67
2002	74.32	-1.22	75.54
2003	172.79	58.42	114.37
2004	178.29	259.45	-81.16
2005	237.03	273.41	-36.38
2006	282.99	256.99	26.00
2007	435.87	179.74	256.13
2008	389.27	199.66	189.61
2009	292.94	254.61	38.33
2010	133.84	121.74	12.10
Totals	**2,524.50**	**1,824.72**	**699.78**

Source: Page 743 in International Financial Statistics 2011, IMF: Washington DC, 2012

Billions of Pounds Sterling

Year	Inward Portfolio Investment	Outward Portfolio Investment	Net Inward Portfolio Investment
2000	172.18	65.56	106.61
2001	40.83	86.55	-45.72
2002	49.74	1.01	48.73
2003	105.65	36.27	69.38
2004	97.34	141.01	-43.67
2005	129.05	150.96	-21.91
2006	152.52	138.84	13.68
2007	217.91	91.51	126.40
2008	200.58	-123.18	323.76
2009	191.58	164.69	26.89
2010	92.94	82.51	10.43
Totals	**1,450.32**	**835.73**	**614.59**

Source: Table 7.1 , page 66, in the 2011 ONS Pink Book

Why did so many British companies get sold to foreign buyers over this period? The main reason is that it was far easier for foreign purchasers to buy UK companies than those in any other country. Prior to 1999, acquisitions of UK companies were liable to public interest scrutiny by the Monopolies and Mergers Commission, but this organisation was then abolished to be replaced by the Competition Commission. This latter organisation had a much narrower remit, concerned solely with whether changes in company ownership would prejudice competition. The result was that the UK was left with no process for reviewing whether the wider interests of the British economy were likely to be compromised by the purchase of UK companies by foreign interests. This left those who were the main beneficiaries of all the fees to be earned by changes in ownership – typically about 3% of the total consideration[3]– with massive incentives to promote these purchases. If 3% was a typical figure earned by the City on the gross value of sales of all UK portfolio assets during this period, its total earnings from this source would have come to something of the order of £40bn.

UK industries now almost entirely under the control of foreign purchasers include everything from our airports to our water companies

The sales of British companies which then took place covered vast swathes of the British economy. UK industries now almost entirely under the control of foreign purchasers include everything from our airports to our water companies, from rail franchises to our harbours, from power companies to our chocolate factories, from chemical companies to merchant banks. Why did we allow this to happen? It was because almost the whole of the political and economic establishment in the UK during this period was in thrall to the proposition that the market knows best. If there were willing buyers and equally willing sellers, why should the state interfere? Why did it matter who owned major British companies, provided they were well run?

No other country in the world came anywhere near allowing key industries to fall into foreign ownership on the mass scale which was permitted

While it may have seemed to the powers that be in the UK at the time that no great harm and potentially substantial benefit could come from the wholesale disposal of British assets, this was never a point of view which was accepted anywhere else. No other country in the world – and certainly no other developed country in the Western world – came anywhere near allowing key industries to fall into foreign ownership on the mass scale which was permitted – even encouraged – in the UK. All of them had national public interest hurdles which had to be overcome. This did not mean that no foreign acquisitions took place but it did raise the bar to a point where a good case had to be made for acquisitions going ahead rather than it being assumed as a matter of course that they should be waved through, provided only that they were not deemed to be anti-competitive.

Looking back on the 2000s, it is very hard to say that all these other countries were wrong, because there are, in fact, very major problems entailed in having very large sectors of the UK's economy being sold off to foreign interests. There are at least four crucial respects in which this is so, these being:

Management

When any company is bought by another one based abroad, it is inevitable that control will pass to those whose focus is primarily based not on the UK but on their home markets. This is where research and development will tend to be concentrated. This is where the loyalties of top management will lie. This is where taxes are more likely to be paid and where the links between the businesses concerned and the government are likely to be strongest.

Investment

When acquisitions are made by foreign companies, it is not unusual for undertakings to be given that investment levels will be maintained and factory closures minimised or avoided. These assurances, however, are always time limited, and when trading conditions worsen and hard choices have to be made, most companies will give preference to their home markets. There is a huge problem, for example, in the UK at the moment where most of our power companies are foreign-owned. They all have serious problems

about raising the capital required for investment and pressing needs for large scale investment in the countries in which they are headquartered. Are they really going to be able and willing to provide the expenditure we very badly need in the UK to avoid power outages in a few years' time?

Profits

When a British company is sold to a foreign owner the flow of future profits goes with the ownership. Of course there is a temporary infusion of funds to the UK as the assets are sold but this is at the expense of losing the right both to future profitability and to any growth in value of the assets which had been lost to UK ownership. There is a very unfortunate parallel here between the potential benefit of North Sea oil from the 1970s onwards and the huge sale of UK portfolio assets in the 2000s. In both cases the proceeds were used to pay for imports we could not otherwise have afforded while opportunities to invest the proceeds for the future were ignored.

The Exchange Rate

When allowed to take place on a big enough scale, the impact of very large volumes of net sales of portfolio assets to foreign companies is to make the exchange rate much stronger. This is exactly what happened in the UK with the negative affect that exports were priced out of the market. This is why the sale of so many UK companies in the 2000s was a major factor in undermining the rest of the economy's capacity to compete in the world. Hardly surprisingly, manufacturing as a percentage of UK GDP fell between 2000 and 2010 from 17% to 11%[4], while the numbers employed fell from 4.2m to 2.8m[5]. The net sale of British portfolio assets during the 2000s financed the current account deficits which in turn prevented the over-valued exchange rate from falling and greatly damaged our ability to compete in the world.

Was this a sensible way to run the economy? It is hard to believe that it was.

Notes

1 Euro Sterling historical exchange rate table on the Western Union website.

2 Dollar Sterling historical exchange rate table on the Western Union website.

3 3% was the figure published as the fees earned by the City when Kraft took over Cadbury's.

4 Data on Manufacturing as a percentage of GDP on the World Bank website.

5 ONS Labour Market Statistics Release [online], November 2012, table EMP13: 'Employment by Industry'.

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