Britain, the Euro and North America

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Introduction

In the June, 2001 British general election, Tony Blair's Labour government was returned to power for another five years. The big issue for Prime Minister Blair is when to call the referendum on Britain joining the European single currency. On 1st January 2002, France, Germany, Italy, Spain, Belgium and the other 12 members of the Euro will stop using their sovereign currencies for personal transactions. Instead, they will use the common Euro. Since 1st January 1999, companies and governments have been using the Euro and there has been a centralized monetary policy from the Frankfurt-based European Central Bank.

Should Britain join the Euro, give up the pound, sacrifice its monetary policy and integrate itself politically as well as economically with Europe? While this is a political issue as well as an economic issue, what do the data indicate about British interdependence with the rest of the EU? Briefly, the empirical evidence is that British/North American economic linkages are just as strong as British/European ones. While a slim majority of British trade is with Europe, only a minority of British foreign direct investment is with Europe. In fact, over 60% of it is elsewhere, with nearly 50%, in North America. The United States is the largest single foreign investor in Britain, holding 40% of the inward stock.

Currently, 70% of British voters reject British membership of the Euro. They think that Britain will be better off outside Euro-land. London is a leading world financial center and Britain holds a global, rather than a regional, business position. Britain needs to consider institutional arrangements to govern and foster its economic interdependence with North America, as well as its economic relations with the EU.

Trade Data

It is widely believed that Britain is economically integrated with the rest of Europe. The evidence used consists of trade data. Indeed, in 1999, nearly 59 percent of the exports of the UK went to the other 14 member states of the EU. But this has actually declined from a high of 61 percent in 1991, and was running at about 53% for most of the 1990s. In contrast, in 1999, only 14.7 percent of UK exports went to the United States, up from 10.9 percent in 1991, and around 12% for most of the 1990s. These data are reported in Table 1. Data for UK. imports by major regions are reported in Table 2, and show a similar pattern to the export data.

Table 1 here

Table 2 here

Foreign Direct Investment Data

Over the last 40 years we have observed the rise of multinational enterprises (MNEs) and the global spread of foreign direct investment (FDI). Today world business is dominated by the largest 500 MNEs in the world, virtually all of them from the "triad" of the United States, EU and Japan. These 500 MNEs account for over 90 percent of the world stock of FDI and, themselves, do over half of the world's trade, often intra-firm Rugman (2000).

British economic integration with Europe is much less striking when using FDI data. Indeed British FDI in North America has increased remarkably in recent years.

In terms of UK outward stocks of FDI, in 1999 there was 45.4 percent in North America but only 35.5 percent in the EU, down from 42 percent in 1997. The recent dramatic increase in British FDI in North America is reported in Table 3.

Table 3 here

In 1999, only 46 percent of the total stock of FDI in the UK came from the EU. The largest single foreign investor in the UK was the United States, accounting for 40 percent. The total FDI from North America (given that Canada is a large investor in the UK) was 42.6 percent. These data are reported in Table 4.

Table 4 here

In other words, Britain's inward stock of FDI is split between the EU and North America. The North American ownership of Britain's assets range from Ford UK to the Daily Telegraph. Surely, the UK government should be doing just as much to safeguard the jobs and related businesses which are dependent upon North America as upon the EU? A trade and investment pact with North America is needed. This could be as an associate member of NAFTA, or the FTAA if the latter is successfully negotiated by 2005. This does not require that the UK join NAFTA, but that a separate agreement be concluded. The UK needs tariff-free access to North American markets. The North Americans need long-run national treatment safeguards for their FDI in the UK.

This affiliation with North America would be incompatible with the UK joining the Euro and remaining as a full member state of the EU. But Britain could retain its economic affiliation with Europe through a free-trade agreement. The UK could revert to being a member of the European Economic Area (EEA). The former seven members of EFTA include the UK, Austria, Sweden and Finland, who have now all joined the EU. But Norway remains a member of the EEA. As such, Norway has full tariff-free access to the EU, and it also benefits from national treatment for investment.

If the UK keeps an economic affiliation with the EU. through its membership of the EEA, then there is little or no economic cost in leaving the EU. But there are major political benefits. Britain need not join the single currency, adopt a common social policy, nor accept judicial rulings from the European Court of Justice. With a free trade agreement, instead of a common market linkage with the EU, British sovereignty is retained at no economic cost.

It is acknowledged that the UK needs to retain a strong economic linkage with Europe. This is especially important for British inward investment (Table 4), which is less focused on North America than is British outward investment (Table 3).

Recent Direct Investment and Currency Changes

The stock of British FDI in the United States nearly doubled in 1998 and almost tripled in 1999 as compared to the 1997 level. It went up by GBP 62,699mn to the level of GBP 121,782mn in 1998 and by GBP 63,581mn to the level of GBP 185,363mn in 1999. At the same time, the EU received only GBP 6,492mn (or 10.4% of the US inflow) in 1998 that brought up the level of British outward investment in the EU to the level of GBP 98,564mn. However, in 1999 British companies became much more proactive in their attitude towards investing in the EU countries. As a result, the FDI stock was augmented by GBP 51,594mn to the level of GBP 150,158 as of the end of 1999. Nevertheless, the EU share still constitutes only 35.5% of the total outward FDI stock, whereas the US part amounts to 43.8% of the total. Therefore, the importance of the United States as an economic partner for the UK is more than evident. The following chart helps to illustrate the point further.

Chart 1 here

Chart 1 depicts the level of the recent flows of outward foreign direct investment and the sterling/US dollar and sterling/Euro exchange rates. The data cover the 1999-2001 (first quarter) period on a quarterly basis. The data for the currency exchange rates are depicted with a one period lag since it is assumed that the exchange rate may have a delayed impact on the direct investment flows. For the sterling/US dollar exchange rate, chart 1 demonstrates the classical effect of exportsubstitution foreign investment (when appreciation of local currency weakens the competitiveness of exports and pushes a company to set up production facilities abroad instead of exporting). The depreciation of sterling is followed by periods of low investment by UK companies anywhere in the world, whereas appreciation of sterling relative to the US dollar provokes surges in investment activities by UK companies.

However, no relationship between the level of investment and the sterling/Euro exchange rate can be detected. Therefore, it may be inferred that the US dollar has a much stronger impact on investment decisions of UK companies than the Euro. Consequently, UK economic links with the United States are very robust and should be taken into account when making decisions about the future of sterling and the euro.

Chart 2 confirms this point. It reports the UK net foreign direct investment flows and the sterling/US dollar and sterling/Euro exchange rates. Again there is a lagged relationship between net inflow of direct investment and the sterling/US dollar relative exchange rate. However, there is no relationship between the sterling/Euro exchange rate and net direct investment flows.

Chart 2 here

Conclusion

These data suggest that the UK must have two economic relationships; one with Europe and one with North America. This is possible with two free-trade and investment agreements. The current Blairite one-dimensional focus on European integration presents major political and social pitfalls for the UK. While a majority of British trade is with the EU only a minority of both inward and outward FDI stocks are with the EU; as much, or more, is with North America. As a consequence, Britain needs to revert to balanced economic diplomacy.

Reference

Rugman, Alan M. (2000) The End of Globalization. London: Random House; New York: Amacom; Toronto: McGraw Hill-Ryerson.

Table 1

UK Exports by Region 1991 - 1999

(percentage of total exports)

	1991	1993	1995	1997	1999
Europe	69.7	58.2	59.8	61.9	64.1
EU	60.5	52.1	53.9	52.7	58.7
North America	12.8	14.8	13.6	13.6	16.8
USA	10.9	12.9	12.2	12.2	14.7
Asia	10.6	2.3	13	13.1	8.5
Japan	2.2	2.2	2.5	2.6	2.0
Other Countries	6.9	14.8	13.6	14	10.5
World Total	100	100	100	100	100

Note: Total Europe includes EU and other Western Europe (Norway, Switzerland, Turkey, Iceland) plus Poland, Czech Republic and Hungary.

Total Asia include Japan, South Korea, Indonesia, Brunei, China, Hong Kong, India, Malaysia, Pakistan, Philippines, Singapore, Taiwan and Thailand.

Source: UK Office for National Statistics for 1999 data.

Table 2

UK Imports by Region 1991 - 1999

(percentage of total exports)

	1991	1993	1995	1997	1999
Europe	62.6	62.6	63.8	61.1	60.4
EU	57.3	55.0	56.8	54.4	53.9
North America	13.5	13.3	13.5	14.9	14.6
USA	11.7	11.7	11.9	13.3	12.7
Asia	13.3	15.6	15.2	14.0	16.9
Japan	5.5	6.0	5.6	4.9	4.8
Other Countries	10.5	8.5	7.6	10.0	8.1
World Total	100	100	100	100	100

Note: Total Europe includes EU and other Western Europe (Norway, Switzerland, Turkey, Iceland) plus Poland, Czech Republic and Hungary.

Total Asia include Japan, South Korea, Indonesia, Brunei, China, Hong Kong, India, Malaysia, Pakistan, Philippines, Singapore, Taiwan and Thailand.

Source: UK Office for National Statistics for 1999 data.

Table 3

UK, Outward Stocks of Foreign Direct Investment

(percentage of total investment)

	1995	1997	1999
Europe	38.9	45.5	39.9
EU	37.0	42.2	35.5
North America	34.5	30.3	45.4
USA	31.6	27.1	43.8
Asia	9.2	8.9	6.0
Japan	1.2	0.7	0.9
World Total	100.0	100.0	100.0

Source: Office for National Statistics, ONS Overseas Direct Investment Inquiries, Bank of England, London.

Table 4

UK, Inward Stocks of Foreign Direct Investment

(percentage of total investment)

	1995	1997	1999
Europe	40.5	37.9	50.0
EU	33.7	29.4	45.6
North America*	44.8	48.6	42.6
USA	42.8	45.9	39.6
Asia	6.2	6.0	2.2
Japan	4.3	4.3	1.4
World Total	100.0	100.0	100.0

Source: Office for National Statistics, ONS Overseas Direct Investment Inquiries, Bank of England, London.

* North America includes the USA and Canada

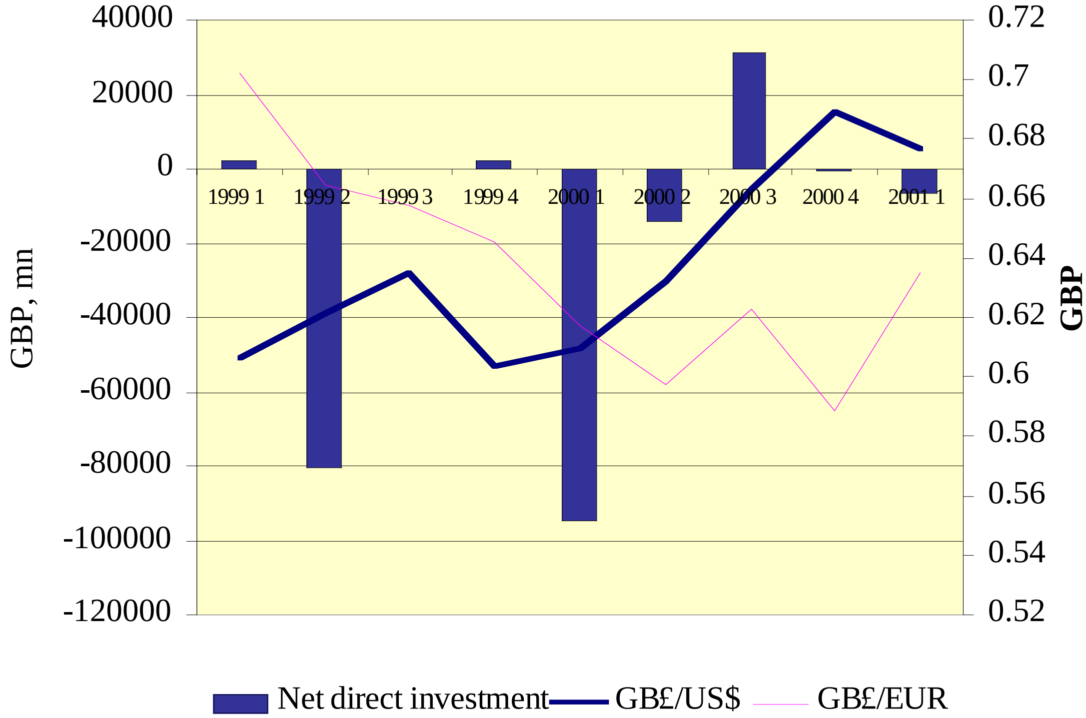
Chart 1

UK Outward Direct Investment and the Euro and US dollar, 1999-2001

Source: Office for National Statistics, ONS Overseas Direct Investment Inquiries, Bank of England, London.

Chart 2

UK Net Direct Investment and the Euro and US dollar, 1999-2001



Source: Office for National Statistics, ONS Overseas Direct Investment Inquiries, Bank of England, London.