

**FOREIGN INVESTMENT IN THE UK\***

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**\* Preliminary**

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## FOREIGN INVESTMENT IN THE UK

### Introduction

In this paper we examine foreign investment in the UK – a perhaps puzzling, even paradoxical, issue to explore, since the UK is itself, even before adjusting for the size of the British economy, one of the world's biggest overseas investors. This, we would conjecture, may go a long way to explain what we find. But to go immediately to our conclusions would be distinctly premature. We start by outlining the rest of the paper. In the first section we provide some historical background, setting UK investment in a long-run context. Then we turn to some possible approaches to the analysis of inward investment. Having laid these out, we follow that with some hypotheses based on them. There is then a review of previous work on inward investment into the UK. Then we set out our data, and, having discussed its limitations, test our hypotheses against it. Then we seek to draw some conclusions.

### Historical overview

In the two or three hundred years prior to 1800 the prevailing political and economic philosophy was mercantilism. This means different things to different people at different times and in different countries. But at its core was a concern with the centrality of the state and with state building. It was generally believed that the best means of achieving that was by regulation. Regulation extended to most, even all, parts of the economy and had particular implications for international trade and payments. The result was that international trade was distorted and so were accompanying capital movements.

Thus it was the advent of the reaction against this system in the nineteenth century that saw trade increase hugely and capital flows grow at the same time. Britain was the leading industrial and financial power in the nineteenth century and therefore played the major role. It was the world's largest economy and the greatest trader. From the middle of the century it began exporting capital on an ever increasing scale. The period 1870 to 1914 was one of extraordinary flows. Britain was consistently lending several per cent of its national income over these years, culminating in a rate of around 10 per cent of national income in the few years immediately prior the First World War.

These capital flows began by going to Europe and then to further and further afield, to India, North America, Latin America, Australasia and elsewhere. The capital flowed into all parts of the infrastructure: ports, railroads, mining, and countless enterprises. It meant that by 1914 Britain was a creditor on a vast scale, indeed on a scale never since equalled. In 1914 Britain held approximately £4,000m in foreign assets, mostly portfolio but with quite a lot of direct. This was equal to roughly twice National income at that point. By comparison Japan, the world's biggest creditor of the late twentieth century held foreign assets equal in value approximately to its national income – half the size. Britain was responsible for almost half of all foreign lending in the late nineteenth and early twentieth centuries.

Such capital for development purposes was eagerly sought and willingly given. But there were always those who found fault, and a long-running criticism of the British economy is that it lent too much abroad and so starved British enterprise of needed funds. Even Keynes in 1924 argued this when he criticised the Colonial Act of 1900 for allowing certain British trusts to invest abroad where previously they had to invest in Britain.

In the interwar years Britain's capacity to lend was damaged by its weak current account, and then the Second World War saw the introduction of exchange controls, which were to last until 1979. Furthermore, the Bretton Woods arrangement required and allowed capital controls and the period from the end of the war until the 1970s was one of limited international capital movements. But as exchange controls were lifted and floating exchange rates proliferated so capital began to flow again and in the last two decades of the twentieth century these capital flows have been greater than ever.

The abolition of exchange controls in Britain in 1979 revived the opposition to capital flows and the old arguments began to be heard again. There was by this time a clear political divide between the Conservative Party which favoured open markets and the Labour Party which was opposed. Indeed Labour talked in 1980 of re-introducing controls at the next election which they believed they would win. In a pamphlet ( ) of the time the argument was made that: "since the removal of exchange controls (1979) institutions have invested far too large a proportion of their funds abroad... The City's efforts have not therefore concentrated on the needs of the domestic economy" (p12). They proposed, then, to prevent and reverse such flows through the establishment of a National Investment Board which in turn would direct assets into British industry. Pension funds and unit trusts were the main target and the idea was to cap the overseas content of their portfolios. The ambition was to repatriate substantial capital which would then be channelled in to British industry.

On the other side Britain has also attracted large amounts of foreign investment and although still a net creditor there is substantial foreign ownership in Britain. We turn to an examination of the data below but it is worth remarking here that there has been little evidence in Britain of any public disquiet over the growing extent of foreign ownership. Similarly, in the United States in the nineteenth century when there was quite extensive British ownership of assets there appears to have been little concern – in spite of the antagonism that affected both countries in the late eighteenth and early nineteenth centuries. However, in the second half of the twentieth century when the US again became a substantial debtor and Japanese ownership was prominent there did seem to be some public concern.

### Approach to Analysis

When John Stuart Mill called his book on economics, “The principles of Political Economy”, he was, and one can be absolutely sure this was conscious, using words deriving from classical Greek to signify that he was dealing with the economy, the management of resources, of a national rather than of a family. The modern usage of political economy, at least among economists, differs from that. Economists now try to analyse systematically the effect policy has on the economy; and they do this not in the once-traditional framework of neo-classical welfare economics, where politicians are viewed as benevolent, sometimes even omniscient, social planners, but rather in a framework where policy makers are self interested, responding to political incentives. They are treated, in other words, just like other economic actors, except that they respond to a different, or sometimes additional, set of incentives.

The approach has been fairly extensively applied to the analysis of macroeconomic policymaking. It is one of the ways (although far from the only way) by which it is argued that macroeconomic policy should be guided by rules, rather than discretion; or that it should be delegated to some body not affected by the desire to win elections. A case for central bank “independence”<sup>1</sup> can be constructed by this means. But the approach can also be applied elsewhere.

It has been used to help understand why financial regulation often creates problems and stifles innovation. It can help understand why and when financial regulation will change. This it does by exposing which groups are benefiting from a particular regulatory framework, and what might

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<sup>1</sup> See Capie, Mills, and Wood (1993) for discussion of the various meanings of independence in this context.

change the balance of forces against them so that new groups can change regulation in order to capture its benefits for themselves. Thirdly, it can explore how regulation can protect particular constituencies via its economic effects. The approach when thus applied sees laws and economic outcomes as jointly determined by politics.

Examples of such applications can be drawn from the study of banking, of corporate control and corporate governance, and of securities markets. Kroszner and Strachan (1999) analyse changes in banking regulation in the USA, showing how the timing of branching deregulation was determined by the relative strengths of the affected interest groups. Roe (1999) maintains that the differences in corporate governance between the USA and Continental Europe reflect the “social democratic” political framework of most of continental Europe. Studies (eg Holmsrain and Koplán, 2001) have shown how workers and managers can unite to protect incumbents and to restrict the market for corporate control. Rajan and Zingales (2001) explain the erratic, advancing and retreating, development of securities markets. They suggest that incumbent firms seek to restrict such development as new entrants need access to capital market while incumbents already have a stream of profits. But as free trade opens up goods markets, this not only diminishes the influence of the incumbents but increases the likelihood that they too, will wish access to new sources of capital. Hence is explained the common relationship between changes in financial market regulation and free trade.

Despite these examples, it cannot be denied that “new political economy” explanations are hard to test. This is because they endogenise institutional factors that were previously taken as given, reducing the set of predictions the models can produce. Further, it can be hard to separate ideological from economic determinants of political choices. (Some, indeed, argue that ideology is ultimately economically determined.) Nevertheless, as the approach has proved fruitful in some areas related to the work being done here, we seek to apply it to the present issue.

### Hypotheses

Before setting out our hypotheses, we would note that the “new political economy” or “public choice” approach has found much more favour in the USA than it has in the UK. Economists and analysts in the former country are much more willing to accept, until shown otherwise by the evidence, that politicians and officials are guided by utility maximisation in their public decisions

just as they are in their private ones. We would suggest that the reason for this lies in the different nature of the governmental institutions in the two countries.

Although this is changing a little under Britain's present government, the British civil service at every level traditionally sought resolutely to be apolitical. It did try to carry out what elected politicians wished; but a part of its duty was to encourage caution, to think of an ill-defined but valuable concept of "the national interest". There are also institutions (the office of the Auditor General, for example) with the explicit role of supervising expenditure so that value for money is obtained, and also ensuring that tax payers' funds are spent neither on party-political purposes nor on ways designed to benefit a member or members of that party.

Although unlikely to be infallible these limitations have tended to constrain partisan, as opposed to political, actions.

With that qualification in mind, can the "new political economy" identify groups or parties that might be opposed to, or alternatively favour, inward investment into the UK? What conjectures can be offered?

One can consider the following groups as having an interest: the Conservative, Labour and Liberal parties (the three main parties – in alphabetical order); trade unions, employers' organisations, local governments, and companies that wish simply to sell themselves to the highest bidder.

Unfortunately, when one makes that division what emerges is that the groups have either internally conflicting interests in this matter, or a clear-cut interest but little influence. To see this, consider the groups in the above order. First the Conservative Party. The trouble with this party (in the present context) is that it has no consistent views on what might broadly be termed international economic policy. The views have of course varied within the party – all political parties in Britain are implicit coalitions; and they have varied through time. It was, for example, at one time the party of "Imperial Preference". (See Annex I for details on this.) But at other times it was close to being a party of "Manchester Liberals" (a 19<sup>th</sup> century group which favoured free trade and light if any regulation markets).

Within our data period that latter phase coincides broadly speaking with the period when Margaret Thatcher was Prime Minister; so one hypothesis we explore is that inward investment was likely to be unusually high in those years.

What of the Labour Party? Here, too, there has been some inconsistency. It was for many years the party of state control regulation, of protection of workers. But quite often that did not differ, in this respect, much from the “paternalistic” phase of the conservative party – its early post-war years in particular. We would expect the two parties to differ significantly in the “Thatcher years”; but not really at other times. Again, reflection suggests that trade unions and employers’ organisation would not differ a great deal; both, albeit perhaps for different reasons, would prefer local (ie domestic) ownership of industry. But both would also prefer that firms continue to be active than that they close down. Unions would like it because it creates employment; employers’ organisations because one firm’s activities creates business for other firms. (This last point emerges when we touch, below, on developments in the British motor industry.)

And finally in the interest groups we come to local authorities and firms that are up for sale. These groups have a clearly identifiable interest. Both want more inward investment, the latter for obvious and straightforward commercial reasons, the former because more employment brings prosperity (and popularity for incumbent politicians) and an expanded tax base. So the interest is clear; but so, too, is the lack of influence. There can be persuasion and lobbying from the groups, but that is all. Further, there is no reason to expect these motives or the power behind them to vary over time; so we do not expect much discernible influence on overseas investment from these bodies.

Summarising on interest groups, then, we would expect the Thatcher years to stand out with regard to inward investment; but no other influence is likely to be notable.

This does not mean that we do not expect politics, broadly defined to matter. Tax rates, for example, may well be important. But that is to go beyond the domain of “pressure group politics”.

### Previous Work

This is a useful point briefly to review previous work on foreign investment in the UK. A notable feature of this work is how sparse and fragmentary it is – again a pointer to our conclusion. There

are only four notable studies. These are HMSO (1983), Stopford and Dunning (1983) Stopford and Turner (1985) and Young, Hood and Hamil (1988).

The first of these (which was written largely by Hood and Young) focuses on investment by multinationals in what were that termed “assisted areas” – that is to say, areas in which there was government encouragement to foreign investors. It is thus a source for information on a particular kind of foreign investment; although it does not give the total of foreign investment into the UK. Appendix three lists that data that volume provides. As will be seen, there is a considerable amount of detail but not always the detail one would wish. We do not discuss this volume beyond referring to its data; but we would note that its line with regard to multinational investment, when it is critical, it is critical that there had not been enough of what was, from the point of view of raising both employment and labour productivity, a good thing. Stopford and Dunning’s work is a part of their study of multinationals; so it allows comparisons on inward investment in various countries, and of the kinds of activities the inward investment has been in. But that is as far as it takes us; we do not refer to it further. The volume by Stopford and Turner is mainly an analysis of the effects multinationals have had on the British economy, but in its introductory chapter some data on the extent of overseas investment in the UK are presented. Finally, Young, Hood and Hamil provide a variety of snapshots of data. Annex three lists their data.

Examination of these Annexes will reveal how fragmentary the data of those early studies were, and how they are of little use in revealing trends in the data. Be that as it may, however, what general conclusions did these volumes reach?

(i) Stopford and Turner

Like Young et al, this study focuses on multinational firms; but it is concerned more with the firms and less with the British economy. It addresses such topics as why firms become multinational, the role of US firms, and the responses of British firms. There is, however, a broader perspective in three chapters; two look at the impact on the economy; one at political attitudes. Looking first at employment, they find that there is little evidence that foreign-controlled jobs are ‘more unstable’ than domestically controlled ones. When employment in a sector has declined, the decline has usually been more in domestic firms. They also very cogently observe (pp 167) the following. “The removal of exchange controls in 1979 rekindled a debate that had been discussed for decades: is outward direct investment beneficial or damaging to the health of the economy? Precisely the same question is asked about inward investment. Were clear answers available, the matter would have been settled long ago.”

For example, in assessing the effects on trade, it has proved almost impossible to disentangle the effects of investment from those of openness. Even the Reddaway Report (1968) on British investment overseas, made progress by assuming that without investment the trade would have been lost to the UK. Subsequent work indicated that the two go together, but have had little success in establishing causation or answering counterfactuals.

Answers for employment seem clearer. For example, the following tables supports. Yuong et al’s conclusion on employment – multinationals provide relatively stable jobs.

	1983 Employment (000 jobs)	Job loss (gain) 1972-83 (000 jobs)	Change % 1972-83
Foreign .Controlled	860	(80)	+10
58 UK multinationals	1,336	623	-32
UK .domestic.	3,343	1,558	-32

What did they think the political implications were? Attitudes they describe as being uncoordinated but broadly supportive. Even when there were restrictions on foreign ownership, they are less restrictive than elsewhere. There was concern about foreign ownership of major financial institutions. (We discuss in a separate section developments in the financial sector.) But inward

investment was uncontroversial. An interesting item of evidence cited was referrals to the monopolies and mergers commission. 2.2% of acquisitions by foreign companies were referred to the Monopolies and Mergers Commission between 1978 and 1981, as opposed to 1.6% of acquisitions by foreign companies.

### Young, Hood, and Hamil

The aim of this study was “.. to examine the impact of multinational companies on the British economy, and the British Government’s policy responses.” The period covered was the late 1980s. The authors’ starting point was the British economy’s decline in relation to... its principle competitors”. Ignoring the economic illiteracy of the use of the term “competitors” in this context, what questions did these authors ask, how did they seek for answers and what answers did they find? They saw Britain’s “decline” as due to the decline of its manufacturing industry, and to the extent this occurred to ask how inward investment (by “foreign multinationals”) could reverse this manufacturing decline.

Within this intellectual framework there had already been some previous work. One was by a House of Lords Select Committee on Overseas Trade (1985). This expressed four main points.

- (1) There would not be sufficient inward investment to “... sustain a permanent deficit in manufacturing.”
- (2) “Many British firms had much to learn from foreign practices in the drive to be competitive...”
- (3) There was concern over the high import content of goods produced by foreign companies.
- (4) Government should focus less on the “jobs creating aspects of foreign investment, and more on “the level of manufacturing and value added”.

Further, possibly inconsistently with their desire for British companies to learn from foreign ones, they should be careful about encouraging the input of “foreign R&D” as it might discourage “development of new technologies” by British firms.

The study by Young et al really reflected these varied and sometimes conflicting concerns, and it shared the mercantilist view point under which nations were seen as “competing” in international trade. What kind of firms would come to Britain? Would they use the most sophisticated

technology in their foreign subsidiaries? Would these technologies somehow “transfer” to domestic firms? How should the UK adapt to provide the skilled workers needed by these firms?

The desire to import new technology was of course not confined to Britain. In the 1950s and 1960s, multinational investment was on these grounds generally welcomed. (Dunning, 1974). But in the 1970s, concerns emerged over ownership of raw materials and the dominance of multinationals in the high technology sectors.

By the 1980s opinion seemed to have shifted back to a middle ground. Young et al (op. cit) ascribe this change in part to the recession of the time leading to political focus on reviving employment. Further by the 1980s the UK was still a bigger overseas investor than recipient of foreign investment – by a two-to-one ratio by value (Stopford and Dunning (1983)).

Inward investment had been in decline as a share of total (ie World wide) investment by multinationals. What characteristics did these multinational investors in Britain have? They were, unsurprisingly, important firms. They employed more workers on average than did British firms. They were more productive in terms of output per head, (by between 17 and 30%) and they paid higher average wages (by 15%).

What impact did these firms have? Even before the Thatcher government, British governments, of either party, had adopted a “laissez faire” attitude to foreign investment in the UK. There were attempts to encourage domestic firms, but these were notable for their very limited number. The main examples were the support for Rover (car manufacturing); for Immos (computer chips) the British National Oil Corporation and Britoil (to exploit North Sea oil); and the limitations on foreign share ownership in some privatisations.

Despite concerns about poor UK technology, the technology transfer from investment was not great. The investment had a bias to technology intensive sectors; but of course that did not bring much transfer. There was encouragement to locate R&D in the UK. But the resulting pattern seemed to reflect world-wide trends – for example, the tendency to concentrate R&D in a few locations by pharmaceutical firms – rather than either UK efforts or the lack of them.

Similarly, while in a few sectors multinationals seemed to become dominant, concentration was not greatly affected by their presence, and no evidence was advanced that competition was affected. No

evidence of their having greater success than domestic firms at creating barriers to entry has emerged.<sup>2</sup>

The employment effects were not notable even in areas of high unemployment. But the impact of employment practices was more widespread. Those firms are credited with encouraging if not introducing reduced union power, more firm as opposed to industry wage bargaining, the decline of unionisation, more emphasis on communication with employees, and more stringent recruitment procedures.

Broadly speaking, the effects of investment were seen as sometimes hard to measure, but in broad terms beneficial. It created employment, helped raise productivity modernised work practices, and certainly did not reduce the R&D carried on in Britain.

Detailed studies of employment in deprived areas confirmed the overall view that the impact was favourable. Most studies of this examined the effects of the incentives given to come to these areas and create jobs. The verdict was distinctly downbeat. Firms came to secure market access, to diversify production locations, and at times when the exchange rate made the move look good. Once firms had decided to come to the UK, taxpayer – provided financial assistance was of some relevance to determining location; but even then, the availability of the right kind and quality of labour was more important. (M Breck and M Sharp, 1984.) Interestingly, a point supported by our data for a later period, 1984 changes in subsidies (reducing them, and imposing a “cost for jobs” limit) had no effect. But although foreign investment had a favourable effect on employment, productivity, and overall prosperity in areas of high unemployment, the fear was expressed (by Young et al) that the firms operated in “an antiseptic work environs”. They did not interact with local firms. That concern was, however, based on a study of the electronics industry in Scotland; that may well have been a special case.

The conclusion of the study of the effect of investment in the UK by foreign multinationals was that it was, in every dimension, modest but beneficial. Not surprising, then, that both policy and attitude have been benign neglect, but to this we turn subsequently.

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<sup>2</sup> Their effects on the balance of trade were thought to be ‘favourable’.

## Investment in the UK

Having reviewed the burst of work on FDI in the UK which was focussed on multinationals, we turn now to reviewing a long run of data. Once that has been set out and discussed, we turn to a series of special issues, including some unique to the UK, before drawing some conclusions.

Our data are presented in the text via a series of charts; the underlying data are in tables in the appendix.

For the record, Chart 1 shows real and nominal GDP. Chart 2 plots the UK inflation rate, Chart 3 the £ exchange rate (in three series: £/US\$; £/DM linked to £/€ and the effective rate. Chart 4 plots a short term and a long-term interest rate. We also report at this point which party was in government, and the size of its overall majority (Chart 5). The next two charts are total foreign investment in the UK; chart 6 contains a nominal and a deflated series and chart 7 a series showing the ratio to GDP. One immediately notices the truly remarkable surge at the end of the period. This is not an error, but rather a reflection of a particular aspect of the UK economy; this is discussed subsequently. We then show various breakdowns of foreign investment. Charts 8 and 9 show the breakdown between direct and portfolio investment, in real terms and as a ratio to GDP respectively. Chart 10, the first to reflect a noteworthy aspect of the UK economy, shows investment by oil companies. Chart 11 shows, for interest, investment in government securities. Chart 12 shows total FDI broken down into oil and non-oil, and Chart 13 shows total portfolio investment. Chart 14 shows FDI and portfolio investment together. Charts 15-19 show the same series relation to GDP. The similarly numbered tables in the appendix show the underlying data.

Before discussing these charts, some definitions are necessary. The first two are of direct and portfolio investment.

The definitions below are quotations from the “Pink Book”; the quotations are from the glossary to the 2002 edition.

**Direct Investment** – Net investment by UK/foreign companies in their foreign/UK branches, subsidiaries, or associated companies. A direct investment in a company means that the investor has a significant influence on the operations of the company. Investment covers not only acquisition of

fixed assets, stock building and stock appreciation, but also other financial transactions such as additions to or payments of, working capital, other loans and trade credit, and acquisitions of securities. Estimates of investment flows allow for depreciation in any undistributed profits. Funds raised by the subsidiary or associate company in the economy in which it operates are excluded as they are locally raised and not sourced from the parent company.

Portfolio Investment – Investment in equity and debt securities issued by foreign registered companies, other than that classed as direct investment, and in equity and debt securities issued by foreign governments. A portfolio investment, unlike a direct investment, does not entitle the investor to any significant influence over the operations of the company or institution and represent less than 10% of the equity capital.

A second key issue is how to “scale” the series. Very obviously, in a country such as the UK, which has had high and variable inflation in part of our data set, nominal values can be misleading. This would suggest deflation by the measure of the general price level; and we report the series thus deflated. But this is not our preferred transformation of the series; for there seems to us to be three problems with it. First, is any one of the deflators appropriate when we are concerned with investment goods alone? Secondly, are non-UK companies concerned with the real sterling value of their investment, or rather perhaps the real value of their investment in their home currency? Either is arguable. Third, and most important, it seems to us that a more appropriate approach to scaling the variables is available. This is to deflate the nominal investment series by nominal GDP. This is in our view more appropriate because, insofar as the main focus of the study is attitudes to foreign investment, there are surely likely to be affected not by the “real” value, however measured, of such investment, but rather its size relative to a measure of national income. That usually is therefore the series on which we focus attention.

It should of course be noted that the choice of scaling variable is not very important in affecting the course of the series in the present data set; but it could well be either for the UK in the future, or for other countries.

### The Charts Discussed

We now briefly discuss the charts, before turning to comment, interpretation, special cases, and some slightly novel data.

The levels shown of course all just rise; the nominal series (regrettably) rising significantly faster at times. Chart II shows the variability of the UK inflation rate in part of our data set, and Chart III shows the considerable fluctuations the UK exchange rate has gone through. The interest rate charts

show the behaviour of a short rate (essentially determined by the monetary policy-maker) and a long rate (determined essentially by expectations of inflation in its larger movements).<sup>3</sup> We then show the behaviour of direct and portfolio investment (as defined above) into the UK; we stress again that the remarkable surge is not a data error. And our final charts simply scale the series; the remarkable surge remains.

The first thing to remark is how little there is to remark; the series “bounce around”, so to speak, and not very vigorously, until the mid 1980s. They then start to rise rapidly.

At this point, we should look at our table of governments. For the first, and most obvious, hypothesis is that a climate of hostile governments deterred foreign investment. As is clear, and most notably when one bears in mind our comment on the economic philosophy of Mrs Thatcher’s government, that does not seem to fit the facts at all. One might conjecture that multinationals waited to see if the changes she introduced lasted, and thus say the political hypothesis holds with a time lag. Maybe it does. But at least until there is another change in political climate, the hypothesis thus amended is not refutable, and is therefore of very limited interest.

Moving on from that we can come to ‘economic’ determinants. First, recollect that restrictions on support for inward investment were imposed shortly before the big surge in such investment. This certainly does not show that incentives do not matter; but rather it says that other things matter more. Does the exchange rate regime matter? It is certainly the conventional wisdom that pegged, or even fixed, exchange rates encourage international trade, and also international investment.

But although that is the conventional wisdom, a good body of evidence is inconsistent with it. Bailey, Tavlas, and Ullan (1986) find it does not fit US data; Mills and Wood (1993) find it inconsistent with a long run of UK data; and Carse, Williamson and Wood (1980), by examining the microfoundations of trade, suggest reasons for exchange rate volatility not mattering a great deal. The work of Frankel and Rose (1979) seems inconsistent with that; but several authors have suggested their results were a special case, produced by a wide variety of factors and not just exchange rate regime change.

How well does the conventional wisdom fit the present data set? A reasonable answer would be ‘not at all’. In deed, it is surely rejected by it. Inward investment rises after the abandoning of fixed

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<sup>3</sup> See for evidence on this.

exchange rates, and even further after Britain's departure from the ERM. One could strain, and argue that foreign investors are forward looking, and expecting EMU entry. But this would be hard to reconcile with the caution one must ascribe to them if their behaviour is to be consistent with political regime.

Similarly (and unsurprisingly) neither short term interest rates nor long term rates seem to matter. Indeed, apparently perversely but we shall suggest later not, the lower are these rates the more attractive has Britain been to foreign investment.

Again similarly, economic fluctuations do not seem to matter in the simple sense of booms encouraging and slumps discouraging inward investment.

There is, however, a more complex hypothesis that can be advanced relating FDI to economic variables. This relates it not to fluctuations in any one series or set of series, but rather to what might be termed the 'economic climate'.

Note that the lower level, and greater stability, of both long term and short term interest rates was associated with a move first towards and then actually arriving at an institutional framework which underpinned low and stable inflation. This move was started by Conservative Chancellor Norman Lamont, in a search for some monetary anchor after Britain left the ERM; and was completed by Labour Chancellor Gordon Brown when he gave the Bank of England 'operational independence' to achieve an inflation target as his first action on taking office. That same period coincided with a sustained boom in the real economy. Further, and not apparent in the charts, there is some evidence of an upward change in the UK's trend growth rate in the early 1980s, (eg Mills and Wood). When we add to this that unemployment fell steadily from Britain's leaving the ERM until the time of writing (early 2003), it seems reasonable to say that the economic climate in Britain became more stable, and not only stable but benignly so, from the early 1980s. This may well be seen as a contributing factor to the increase in FDI.

A further factor to note is the change in exchange control restrictions. These were first suspended, by Mrs Thatcher's first chancellor of the exchequer, (then Sir Geoffrey Howe, now Lord Howe) and then abolished. This surely contributed to a feeling that Britain was becoming economically more liberal, more open to the world economy – that it was moving back to the kind of situation, described at the beginning of this paper, which had prevailed when Britain was the major overseas investor.

This ‘climate of opinion’ explanation is very relevant when considering attitudes to investment from overseas. But before we reach these, there are two special industrial cases to consider, and some data on jobs to examine.

Finally in this section, what was the impact of tax? Again, it is hard to see any. Of course when companies are setting up, effective tax rates will vary from company to company. But the period in the first half of the 1970s, when individual tax rates reached 98% and companies were being taxed on nominal profits when inflation was high, with the effect that the companies were being steadily squeezed of capital, did not affect inflows.

### Special Cases

#### (a) Motor Cars

Britain was one of the countries in which motor car production was pioneered; and for some years, especially in the 1930s, mass-production as well as specialist production flourished. The industry then went into a long, initially relative and slow but later accelerating, decline. The British government tempted Chrysler to Scotland; that factory did not prosper. The government promoted amalgamations among the traditional mass manufacturers. That did not prosper, and nor did the specialist firms which were merged in the group. Nothing seemed to work – not industrial relations, not design, and not very reliably the cars themselves.

There is now a thriving motor car industry in Britain once again, and it is largely due to foreign investment that this has come about. Reactions, however, were both curious and mixed. The curious aspect is that there should seem to be different attitudes to two different kinds of foreign investment. When Japanese companies arrived either to set up their own factories (Toyota and Nissan) or originally in partnership with existing firms (Honda’s chosen route) the reaction was a welcoming one. They seemed to be about to bring prosperity to areas of high unemployment; and, indeed, so they did. But that was not the only kind of foreign investment. Other manufacturers tried to save struggling British car manufacturers. This, curiously, seemed to arouse, not everywhere, but certainly to an extent, a measure of hostility. The workforces were somewhat resistant; occasionally the press displayed a little chauvinism. But these companies ended up in foreign hands with the

exception of Rover; and the chauvinism has died down, just as the cars they produced, even under traditional British names, were praised.

We do not go further into the details of the decline and recovery of motor car production in the UK, for that would take us beyond our brief. (Details can be found in, for example ). What is interesting about the episode from our point of view is that, first it is the only example of any note where there have been objections to foreign investment, and second because when asked why they moved to the UK, the “favourable investment climate was a key part of the answer.

(b) The City

In “the City”, the conventional shorthand for the financial industry, there is occasional reference to “Wimbledonisation”. By that is meant the phenomenon notable in regard to the famous tennis tournament played at Wimbledon in south west London, that the facilities are provided in London but all the notable players come from overseas.

There is something of the appearance of the same thing in the financial industry. Following what was known as “Big Bang” in 1986, the traditional barriers between various types of firms broke down. Stock brokers and stock jobbers no longer had to be separate; banks and other financial institutions could own either or both; merchant banks (the traditional raisers of capital for industry) were open for taking over; discount houses, the market makers in government securities, were similarly available. Subsequently building societies, Britain’s traditional, mutually owned, mortgage providers, were allowed to ‘demutualise’ and diversify. By demutualising they became open to take over. Banks, meanwhile, went into the business of mortgage lending. Foreign banks poured into London, taking over businesses, issuing credit cards and so forth.

Britain, because of the euro dollar market, had been an international financial centre already. It then became an even bigger international financial centre, with a large number of important foreign participants. This attracted comment (and the above-noted nickname), sometimes the nostalgic observation that it was a pity the British had lost their dominance, but absolutely no resistance or complaint. There were no objections at all to this wave of foreign investment.

Some reasons are not hard to find. The prices paid for companies, especially early in the process, could often be described as startling, bringing wealth to those who had before enjoyed simply solid

prosperity. And there is a second part of the story. This relates to the curious earnings structure in the financial sector. The aspect of this that is relevant to the present discussion is the division between labour and capital. Employment conditions are very unusual. There is usually a substantial basic pay with the possibility of a bonus payment several multiples of that should the firms and the individual do well in a year. There is also acceptance that job security is low. This has all combined to produce the result that a major part of the profits in good years goes to employees; and in bad years the losses are borne by the shareholders, who may see the workers lose their jobs but do not have the option of smoothing jobs and profits. As a good number of the employees are either British nationals or long-term British residents it is straightforward to see why "Wimbledonisation" has attracted comment, but few complaints.

### Employment and Inward Investment

It is natural to follow the discussion of employment conditions with a discussion of employment numbers<sup>4</sup>.

The table below shows job creation as a result of FDI. The years are financial years, that is to say from 1 April in one year to 31 March in the next. Thus, for example, 1995-96 refers to the period 1 April 1995 to 31 March 1996.

Year	No of projects	Total new of jobs	Total safe jobs	Total associated jobs
1985-86	425	26,686	22,771	49,547
1986-87	359	19,430	13,521	32,951
1987-88	380	33,838	30,222	64,060
1988-89	356	26,862	16,071	42,933
1989-90	379	35,997	41,995	77,992
1990-91	365	23,756	60,900	84,656
1991-92	354	22,423	31,093	53,516
1992-93	332	17,821	43,359	61,180
1993-94	431	29,841	69,645	99,486
1994-95	455	38,351	53,757	92,108
1995-96	492	47,347	51,167	98,514
1996-97	497	46,400	51,939	98,339
1997-98	631	46,562	82,771	129,333
1998-99	669	45,157	75,523	120,680
1999-2000	800	54,365	81,587	135,952
2000-2001	881	71,178	52,359	123,537
2001-2002	835	35,127	24,062	59,189

<sup>4</sup> We are grateful to Invest-UK for the data we discuss in this section.

Some definitions are in order. But there is also an important qualification to the data to note first.

To quote:

“The attached figures are based on projects notified to Invest-UK ..... There is no requirement to notify the Department (of Trade, Industry and the regions) and so the figures include only those projects where the Department’s Invest-UK and its regional partners were involved or which came to their notice.”

The figures are, in other words, an estimate of the lower bound. Other definitional points to note are new jobs are expansion or a new facility, safe jobs, takeovers, of an existing firm. And, oddly, associated jobs is the total of the two.

Now, what light can the data shed? It has to be admitted that it is regrettable that the data became available after the upturn in FDI, thus allowing no comparison with the earlier, pre mid-1980s, period. But within the period they cover, they show a steady, but much gentler, rise in projects than the spectacular rise shown in the previous financial data. This apparent discrepancy is resolved below. The FDI shows constantly favourable employment effects, although the projects–jobs, relationship is highly variable. Interestingly, the number of projects as well as the number of jobs created figures continued to rise even as unemployment in the UK continued to fall; a pool of unemployed labour is not, on these figures, a pre-requisite for inward investment. Again, rather, the data tell a story of a “favourable climate” being important.

### Vast Acceleration

Before summing up, one point remains. What produced the vast acceleration to almost incredible levels from around 1995 onwards? Here we come to a different aspect of London’s role as a financial centre. Full details are given in an annex; so here it is possible to be brief, and essentially make the point by illustration.

When Vodafone took over Mannesman Vodafone paid not in cash but in shares, which were issued in London. The issuing and taking up of these shares produced a surge in investment in a British-registered company, and hence inward investment in the UK. In other words, the sudden surge at the end of our data period reflects M&A activities going on in London; it may well have reversed on more recent data, but these are not yet available.

## Conclusion

It is now time to draw our discussion together. Before doing so we would direct attention to the appendices of the paper where, as well as the various data matters so far noted, there is a brief discussion of FDI in Scotland, and of FDI and the motor car industry.

Just as Britain was a major overseas investor at the end of the 19<sup>th</sup> century, so it has become a significant recipient of inwards investment by the end of the 20<sup>th</sup> and beginning of the 21<sup>st</sup> centuries. Why has this happened? What have attitudes to it been? It is thought to have impinged on or hampered domestic macro economic policy?

We have suggested that a “climate” comprised of various factors has contributed. The abolition of exchange controls re-symbolised Britain’s traditional acceptance of the benefits of economic openness. The liberalisation of the economy made Britain a better place to invest than it had been for some years. The emergence of a policy framework designed to impart economic stability also helped. What did not seem to matter very much at least in the absence of these conditions, was party in government, exchange rate regime, or current state of the economy.

Our verdict on the reasons for overseas investment in Britain thus is very close to what Sir Geoffrey Owen (1999) advanced for Japanese investment in the British Motor Car industry.

“Britain benefited from the (globalisation) process because, thanks to Margaret Thatcher, it had become a more attractive location for investment.”

And note the word “benefited”. It was plainly Sir Geoffrey Owen’s view that there had been benefits. This seems to be the overall view; policy earlier was described as benign neglect. In general, foreign investment was welcomed, and given modest incentives. It was not seen either as important to secure or important to repel. One confirmation of this is provided by statistics on foreign ownership. Figures for foreign ownership of British companies exist; every holding of 3% in a company has to be notified to the stock exchange, as has every further 1% purchased. But no running totals are published; it is thus impossible to say from day to day which British registered companies are owned by British residents. Whether they are owned by British citizens (a somewhat different group from residents) is probably impossible in many cases to find out. Still further confirmation is provided by the complete absence from mainstream political discourse is the notion that “multinationals” have somehow taken over, or impeded the actions of, national government.

All this exemplifies, we conjecture, the relaxed attitude of a major foreign investor. At least at present levels, no-one much worries about “who owns” British industry, so long as British residents have savings somewhere. Foreign ownership is a non-issue in Britain.

**ANNEX 1**

Details to come

## ANNEX 2

Stock of overseas Direct Investment in UK Private Sector

Foreign-Owned Manufacturing Enterprises by Country of Origin: enterprises, Establishments and Employment, 1963-1979

Foreign-Owned and All Manufacturing Unit in UK Regions, 1979

Foreign Ownership in Manufacturing Industry in UK Regions: Share of Employment by Country of Origin, 1977

Importance of Major Industry Orders in Foreign-Owned and All Manufacturing Employment, 1977

Foreign-Owned and All Manufacturing Units in UK regions: Share of Employment by SIC Order, 1977.

Foreign-Owned and All Manufacturing Units in UK Regions: Share of Employment by Size Group of Unit, 1979

Trends in Manufacturing Employment in Foreign Enterprises in UK Regions

Regional Shares of Foreign-Owned and All Manufacturing Employment, 1971-79

Net Capital Expenditure, Net Output and Gross Value Added per Employee in Foreign-Owned and All Manufacturing Enterprises, 1979

Main Characteristics of Foreign Ownership in UK Regions

Foreign Manufacturing Enterprises in Ireland

Foreign Service Enterprises Ireland

Country of Origin of foreign Manufacturing Enterprises in Ireland

Foreign Ownership in Ireland by Industry Sector & Date of Entry

Foreign Ownership in Ireland by Industry Sector & country of Origin

Foreign Ownership in Ireland by Country of Origin & Date of Entry

Appendix: Foreign Openings in UK Regions: Share of Openings by country of Origin, 1966-76

## ANNEX 3

Crude balance of trade (summary by class)

Structure of UK royalty receipts and payments in 1984

Characteristics of foreign manufacturing enterprises in the UK, by nationality, 1983

Characteristics of foreign manufacturing enterprises in the UK, by major sector, 1983

New foreign direct investment projects in the Republic of Ireland and Scotland, 1975-82

Sector distribution of inward direct investment flows in manufacturing industry in the UK

Ratings of UK affiliate produce and process technology

R&D expenditure and employment in foreign-owned firms

R&D in UK majority-owned affiliates abroad

Foreign-owned shares of employment and five-firm concentration ratios, by industry, 1983

Some balance of payments effects of inward direct investment in the UK, 1972-81

Employment in foreign-owned and all manufacturing enterprises, selected years, 1963-83

Employment change in foreign-owned and UK-owned manufacturing enterprises, 1975-81

Workforce characteristics of foreign owned and all manufacturing enterprises in the chemical, and mechanical and electrical engineering industries

Process plant contracting industry: proportion of UK contractors' plant procurement from United Kingdom sources

Ratio of the share of total employment in manufacturing due to first-time inward investors to the share of total manufacturing employment

Regional selective assistance to foreign-owned companies

Openings of foreign-owned plants, by region

Large plant closures in the UK, 1978-82

Net output per employee in foreign-owned and all manufacturing enterprises, 1983

Net capital expenditure of foreign owned and all manufacturing enterprises in the UK assisted areas

Offers of regional selective assistance to the electronics industry, Scotland and Great Britain

Market destination for Scottish electronics industry production, 1978

Purchases of components and subcontract services by Scottish electronics OEMs, 1979

Selected performance indicators for Japanese and all manufacturing plants in Wales, 1981

Sales, profits, exports and employment at IBM UK, 1973-86

## ANNEX 4

### The London Market and Inward Investment

The London market has historically performed as a conduit for portfolio investment across the Atlantic. The City's role as a preeminent financial centre allowed Britain to perform as an intermediary in capital flows both westward across the Atlantic (in the 19<sup>th</sup> Century), and eastward. However, these financial flows have rarely settled in the UK. Yet, with the recent merger boom, exemplified by Vodafone's takeover of Mannesmann, investment has come to settle in the UK. As the consideration for Mannesmann was in share capital, share issuance led to an increased foreign participation in UK financial markets. Several other mergers were funded in this way, leading to a massive increase in both foreign direct investment as well as foreign portfolio investment over the past few years. The most recent Pink Book shows that both categories have returned to their pre-1995 trends. Arguably, therefore, one might conclude that the scale of mergers between UK companies and foreign firms had increased, as opposed to their number. Furthermore, for an increase in foreign holdings in the UK, the mergers must be initiated by UK companies. Therefore, the merger boom displays the increasing international presence of British firms, as opposed to foreign hordes invading the London market. As such, foreign ownership is an acceptable corollary to increased British presence abroad. In this sense, British firms have finally adopted a global scope, which is reflected in increased foreign ownership of their share capital. Given the previous definitions of direct investment and foreign investment, any merger boom fueled chiefly by equity capital will provide a similar increase in foreign ownership.

Therefore, spikes in foreign ownership of UK shares recently tend to reflect an active profile on the part of domestic firms as opposed to foreign capital proactively seeking investment in the UK.

## ANNEX 5

### The Motor Car Industry

In 1960 the British Motor Corporation produced 40% of the vehicles sold in the UK, and produced more new vehicles than anyone else in Europe except Volkswagen. But, to quote Sir Geoffrey Owen (1999):

“Fifteen years later as the largest constituent of British Leyland it was on the brink of bankruptcy and taken over by the government. Fifteen years later still, having changed its name to Rover, it was taken back into the private sector as a subsidiary of British Aerospace, but too weak to survive without an alliance with a larger car manufacturer. In 1994 Rover was sold to BMW of Germany, but this proved no long-term solution.”

Indeed, in 2000 BMW gave up the attempt. Britain’s car industry now owes its success to Japanese manufacturers; earlier-investing US companies (Ford and General Motors) have cut back.

The Japanese firms came, as noted in the text, because of the climate initiated by Margaret Thatcher’s reforms. To continue with another, and more recent, observation from Sir Geoffrey Owen’s work on this subject (Owen 2002), the liberal regulatory environment in the UK has let it offer a more favourable environment for the development of the internet and of e-commerce, and has thus facilitated investment in general.

The generally favourable climate fostered FDI; and it was an aspect of that climate that FDI was greeted with benevolent neutrality.

## ANNEX 6

### The Case of Scotland

Scotland has been poorer than much of England for at least 50 years. Of the regions into which the UK is divided, it has the second highest level of government spending per head and the fourth largest GDP per head.

Successive governments, regardless of party, sought to use state intervention to boost the Scottish economy. Efforts were made to attract foreign investment. This is striking; if we look at another region, the South East of England, a regional agency to attract foreign investment was set up only five years ago – yet around half of US investment in the UK, to take one example, is in the South East. In contrast to that, government expenditure on industrial assistance in Scotland grew nine-fold between 1964 and 1973 (Harvie 1981). Much of this went on assistance to foreign companies. New agencies were also created to plan an economic strategy. The Highlands and Islands Development Board was established in 1965, and the Scottish Development Agency in 1975. Both were given bigger budgets by the Thatcher government.

These policies were continued, sometimes under new names, by the devolved Scottish parliament. Now, it may be hard to argue that these policies were particularly successful. But that is beside the point of the present discussion. They show very clearly how FDI was looked on favourably.

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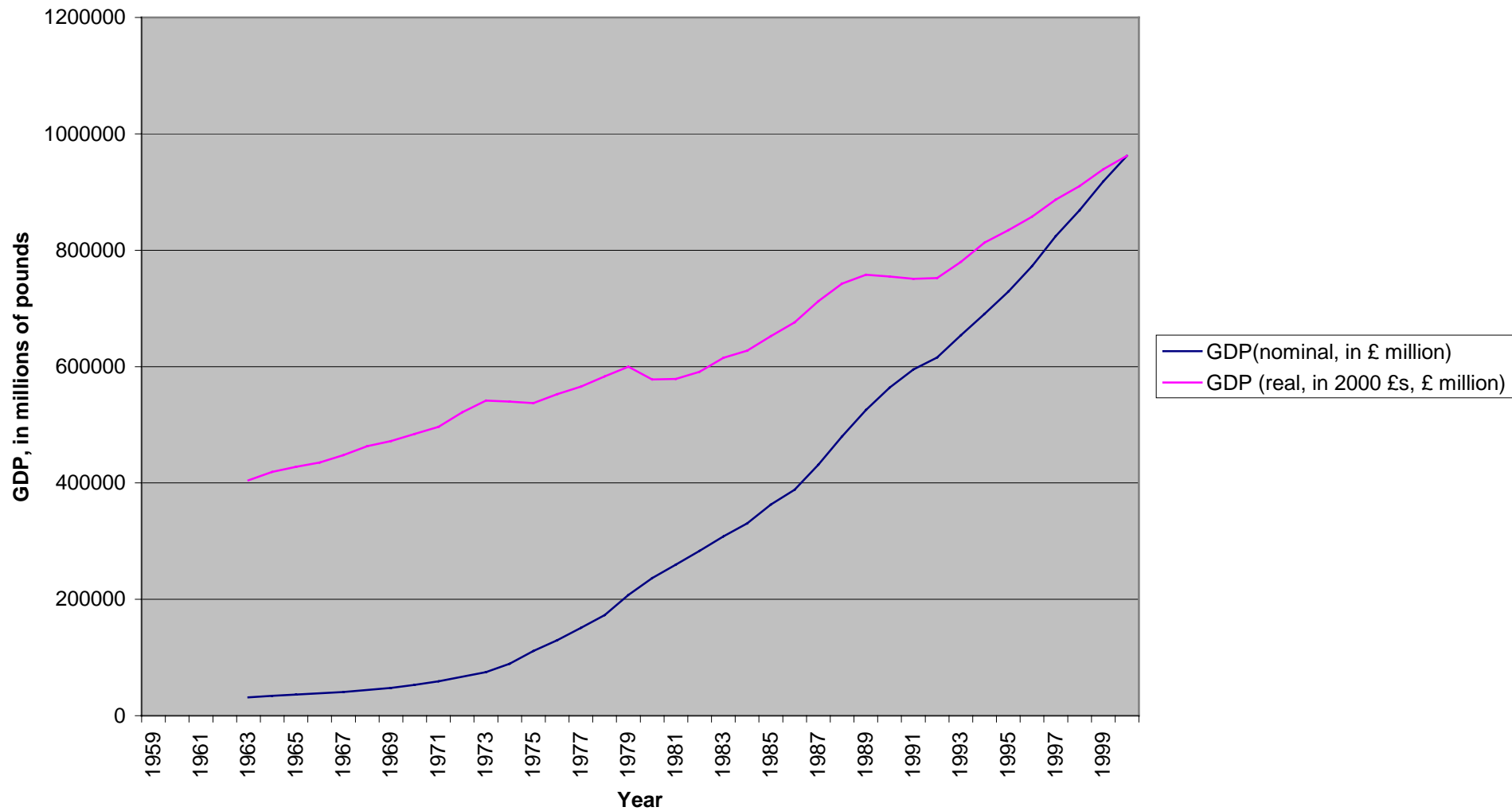
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Chart 1, Real & Nominal GDP in the UK



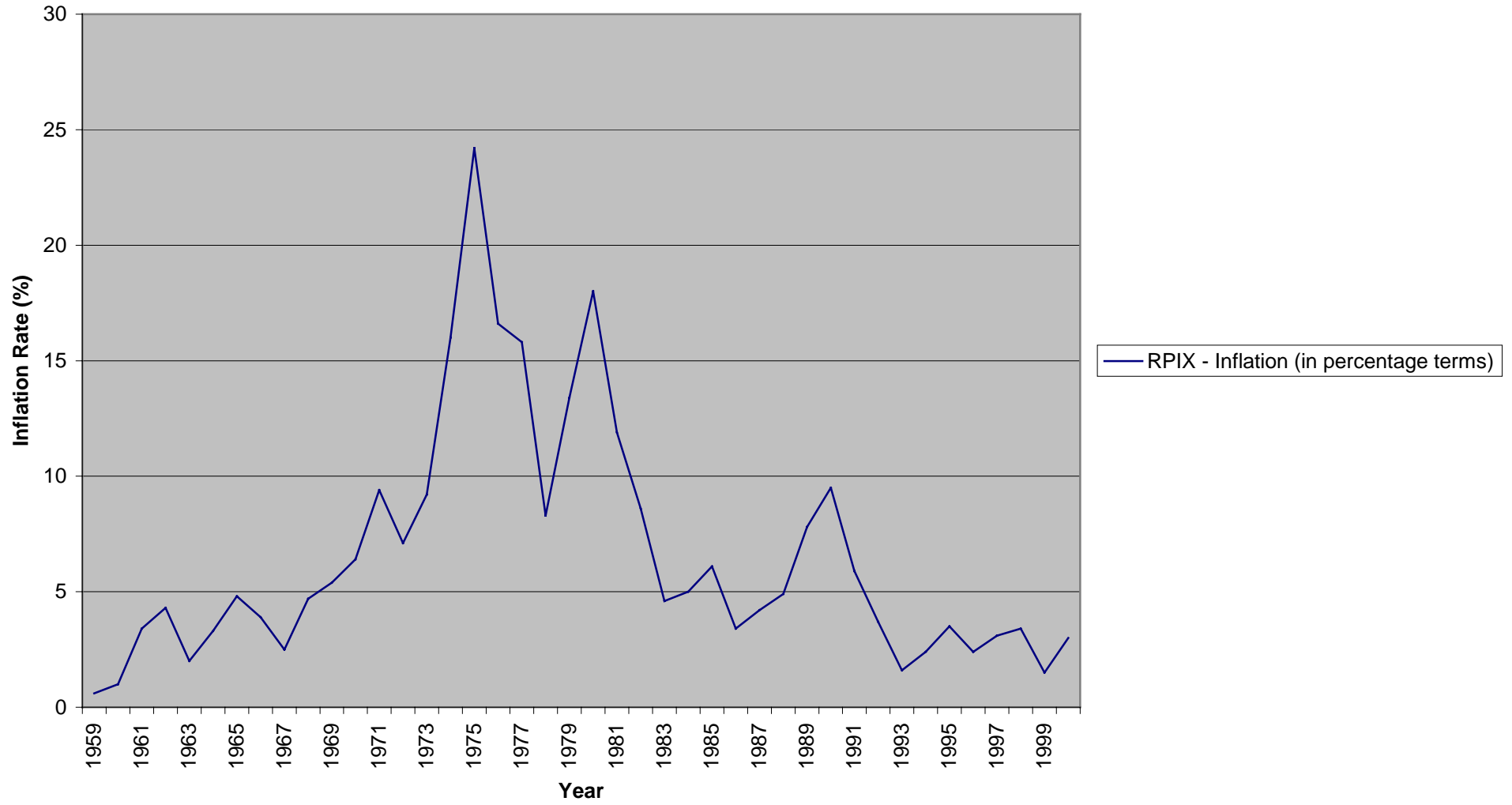
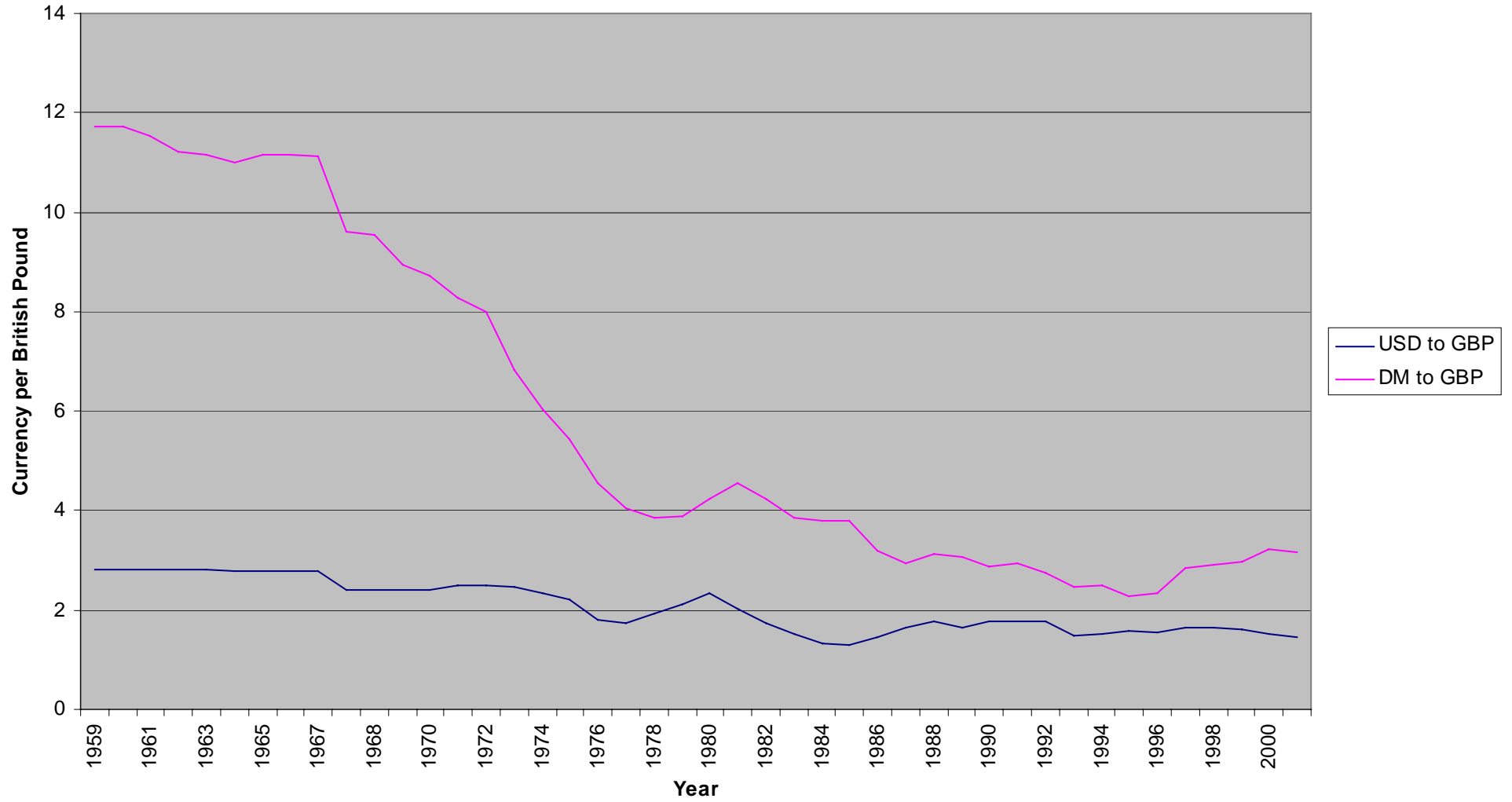
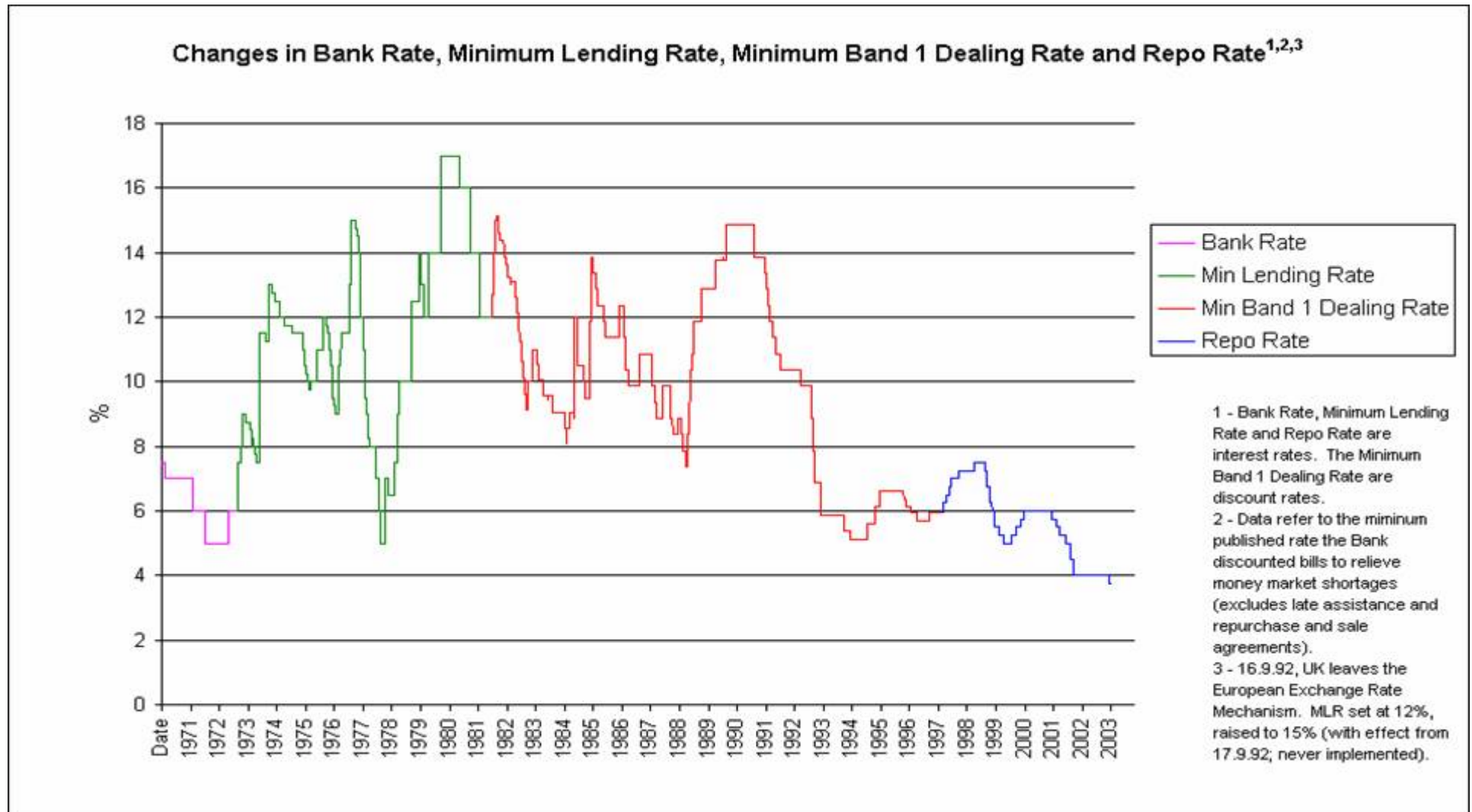
**Chart Two, RPIX - Inflation (in percentage terms)**

Chart Three, Exchange Rates





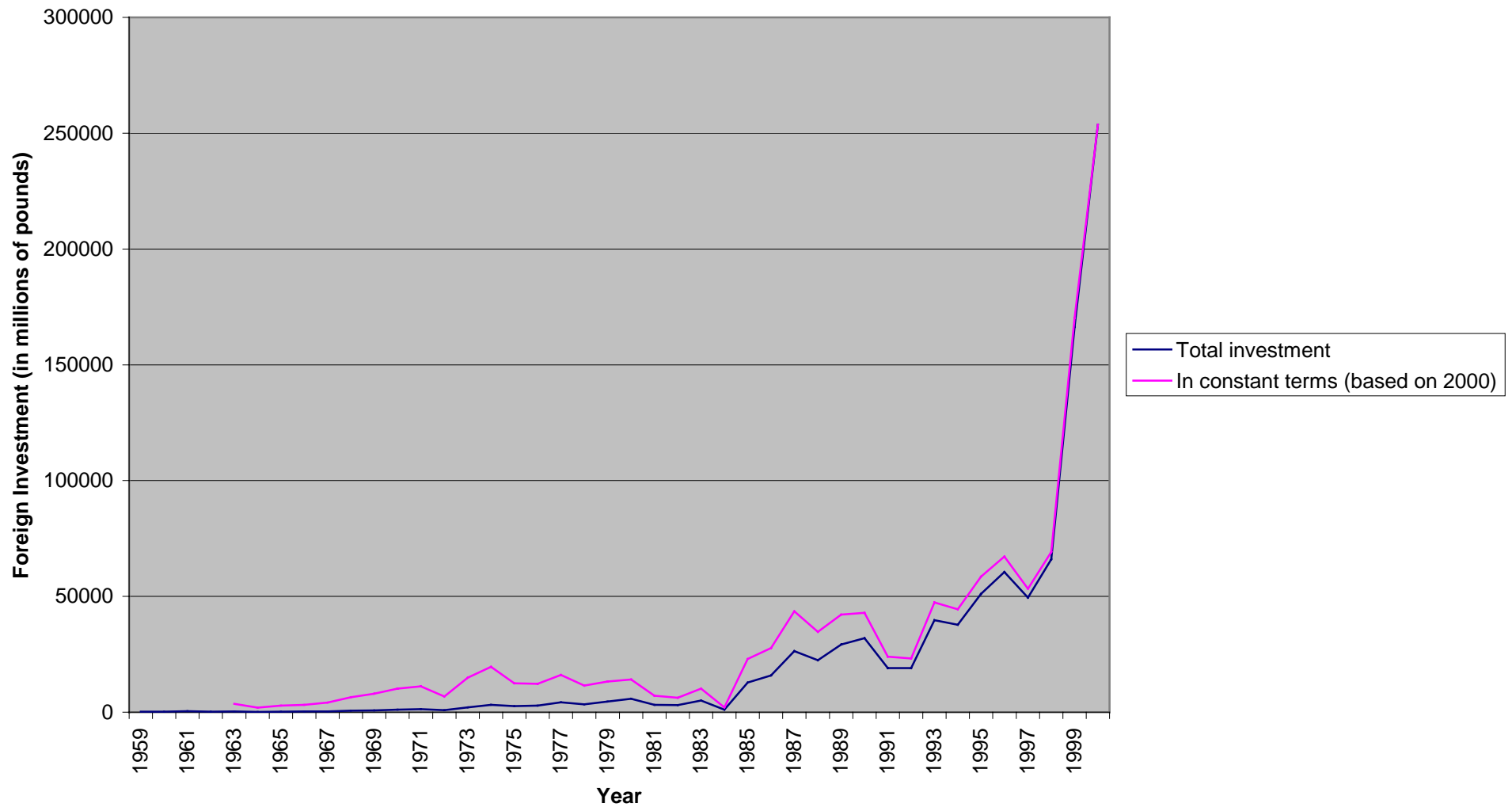
### Chart 5

#### General Election Dates, Governments and Majorities since 1945

<b>Election Date</b>	<b>Party</b>	<b>Leader</b>	<b>Overall Majority</b>
5 July 1945	Labour	Clement Attlee	146
23 February 1950	Labour	Clement Attlee	5
25 October 1951	Conservative	Churchill, then Eden	54
8 October 1959	Conservative	Macmillan, then Douglas-Home	100
15 October 1964	Labour	Harold Wilson	5
31 March 1966	Labour	Harold Wilson	96
18 June 1970	Conservative	Edward Heath	30
28 February 1974	Labour	Harold Wilson	3
3 May 1979	Conservative	Margaret Thatcher	43
9 June 1983	Conservative	Margaret Thatcher	143
11 June 1987	Conservative	Margaret Thatcher	102
9 April 1992	Conservative	John Major	21
1 May 1997	Labour	Tony Blair	179
7 June 2001	Labour	Tony Blair	167

Source: <http://www.psr.keele.ac.uk/area/uk/uktable.htm>

Chart Six, Total Foreign Investment



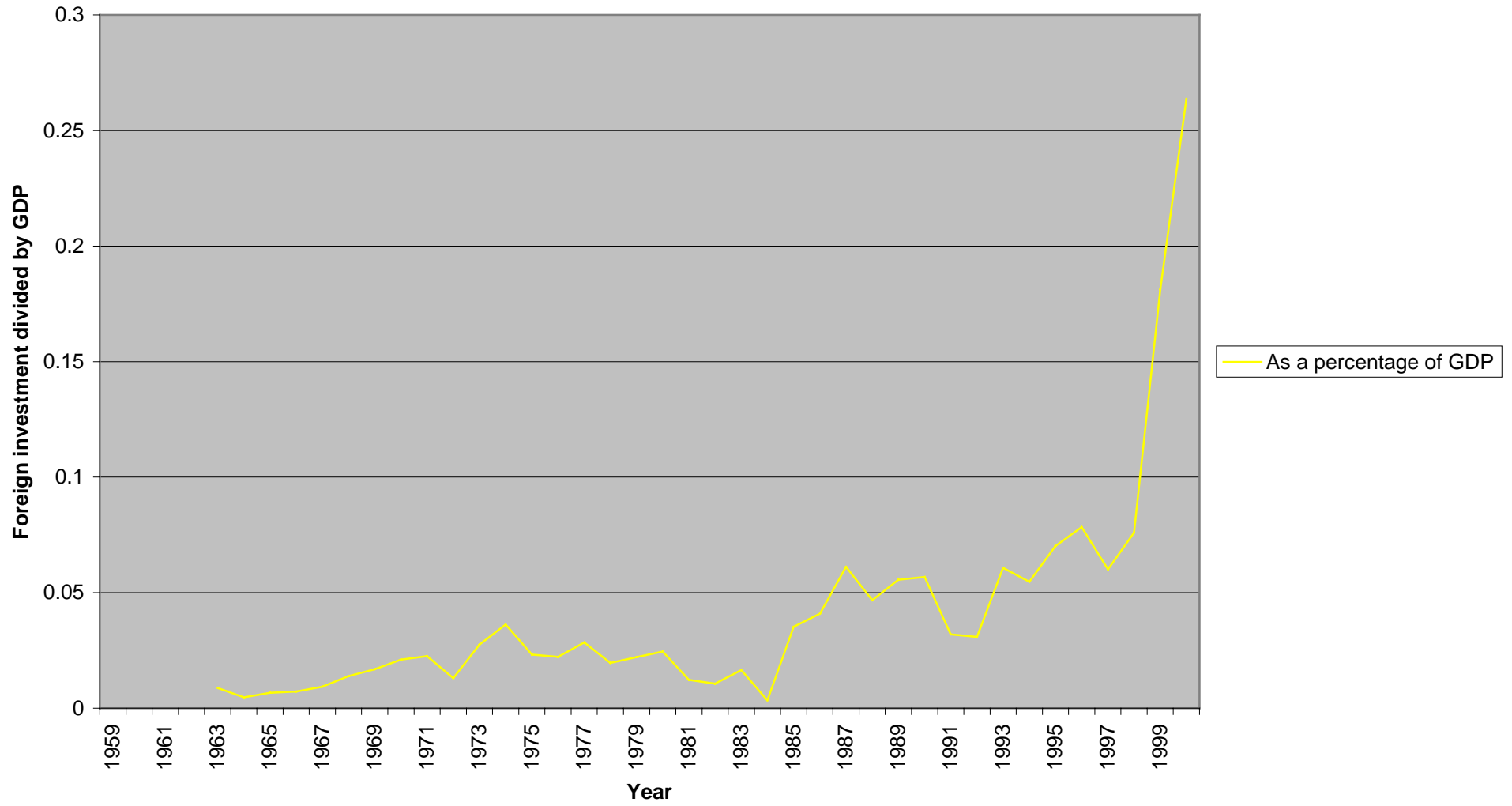
**Chart Seven, Foreign Investment as a percentage of GDP**

Chart Eight, Investment in 2000 prices

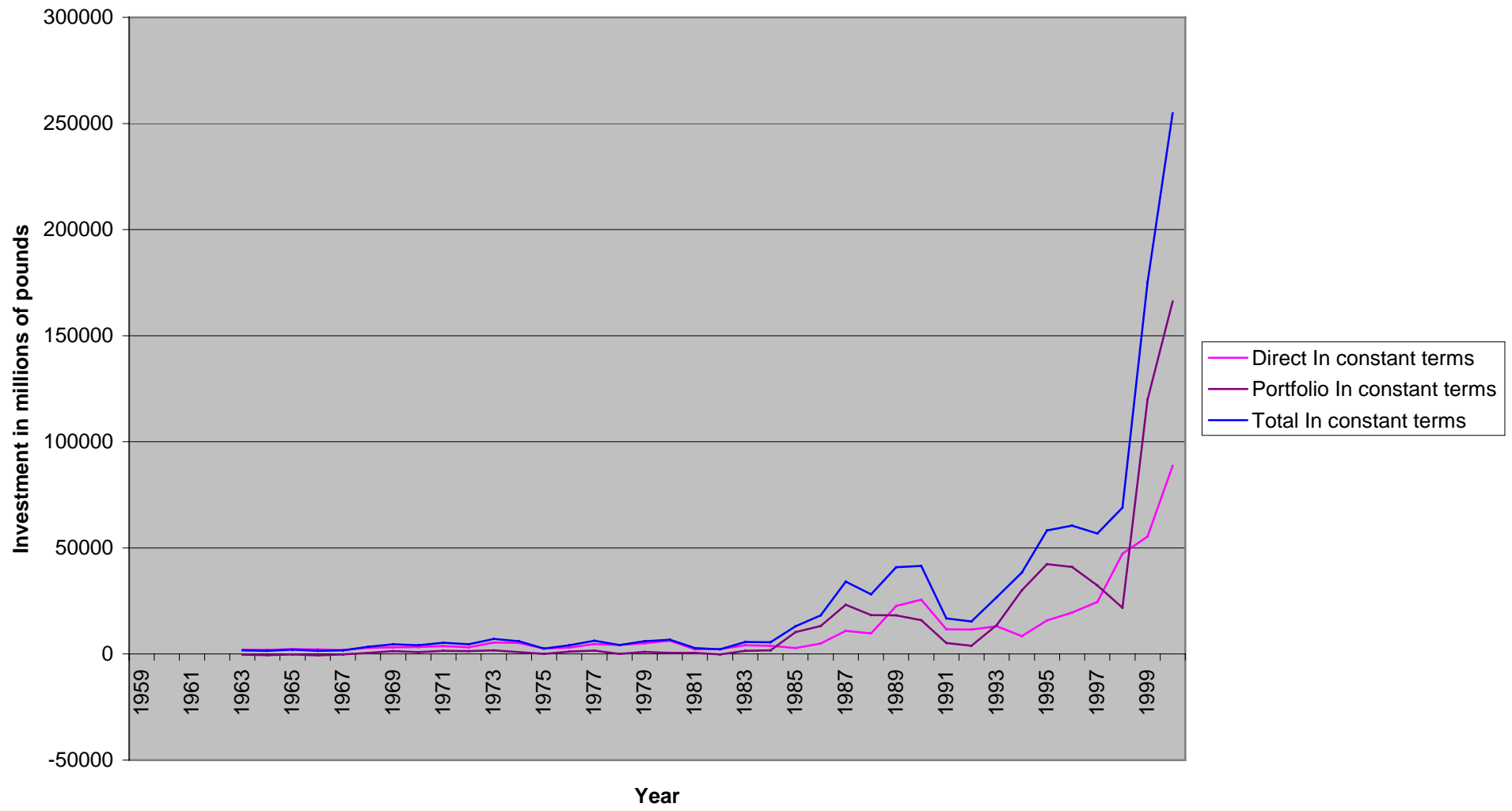


Chart Nine, Investments as Ratio of GDP

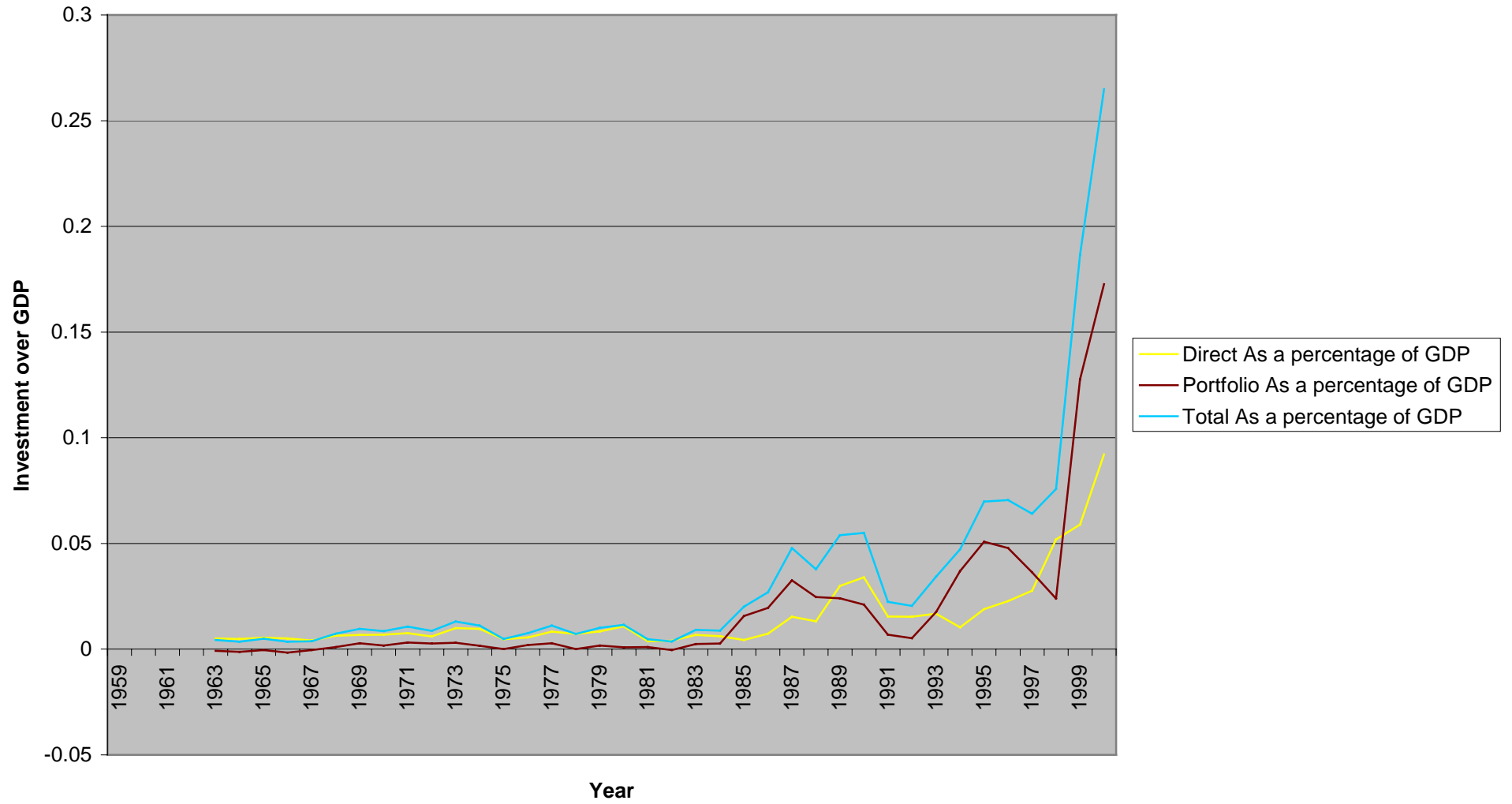
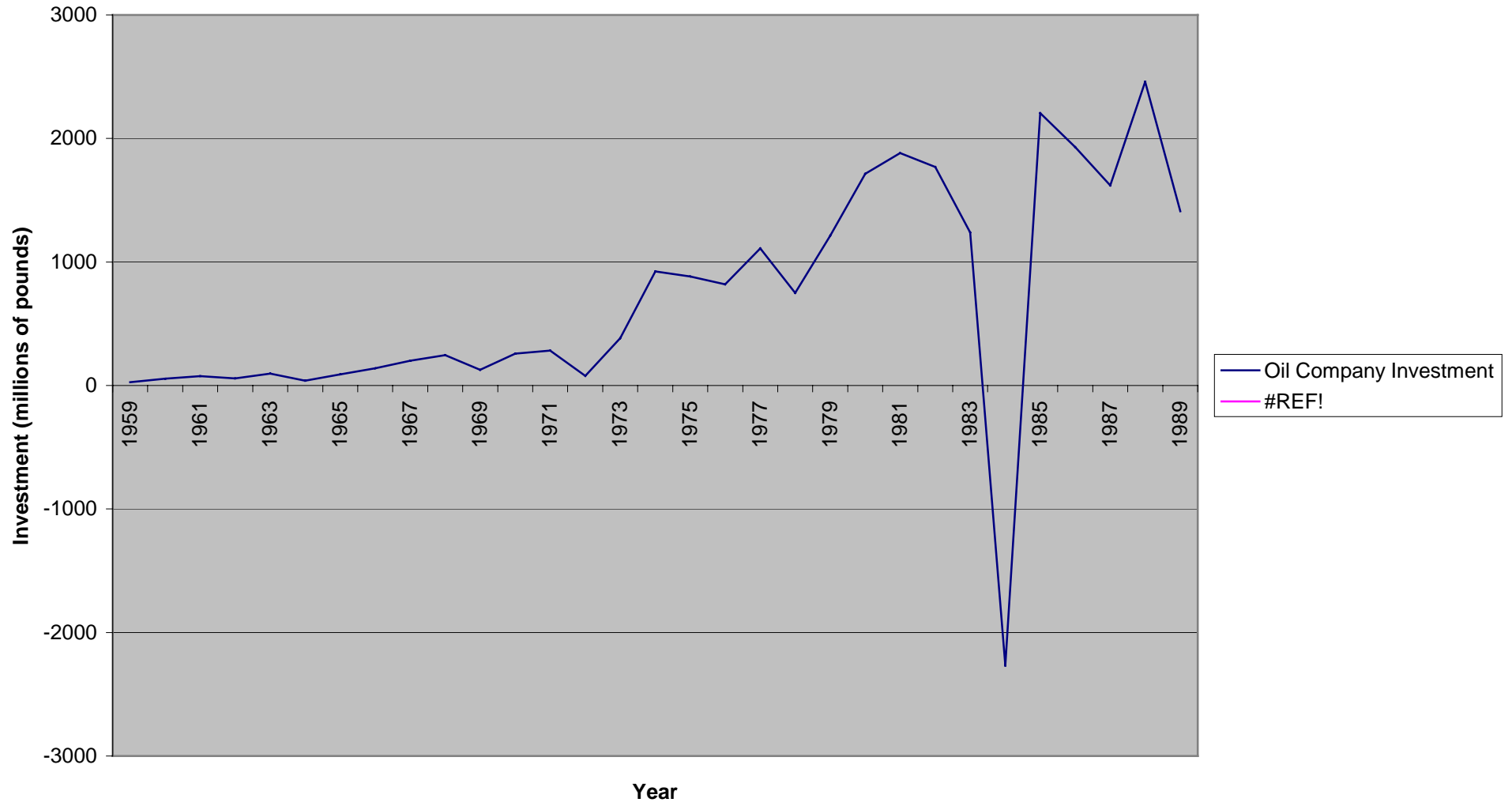


Chart 10, Investment by Oil Companies, 1959-1990



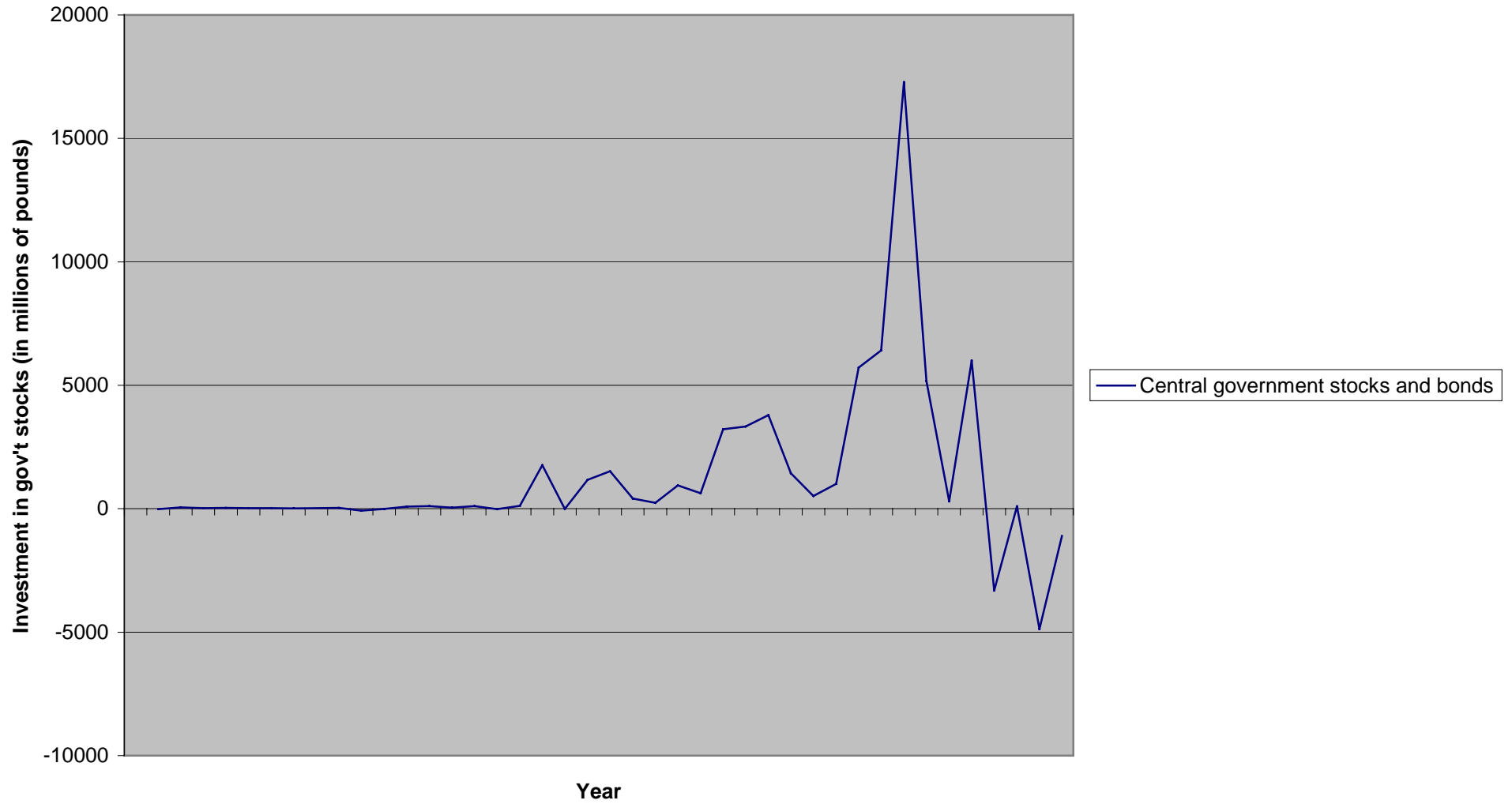
**Chart 11, Investment in Central government stocks and bonds**

Chart 12, FDI broken into oil and non-oil investment

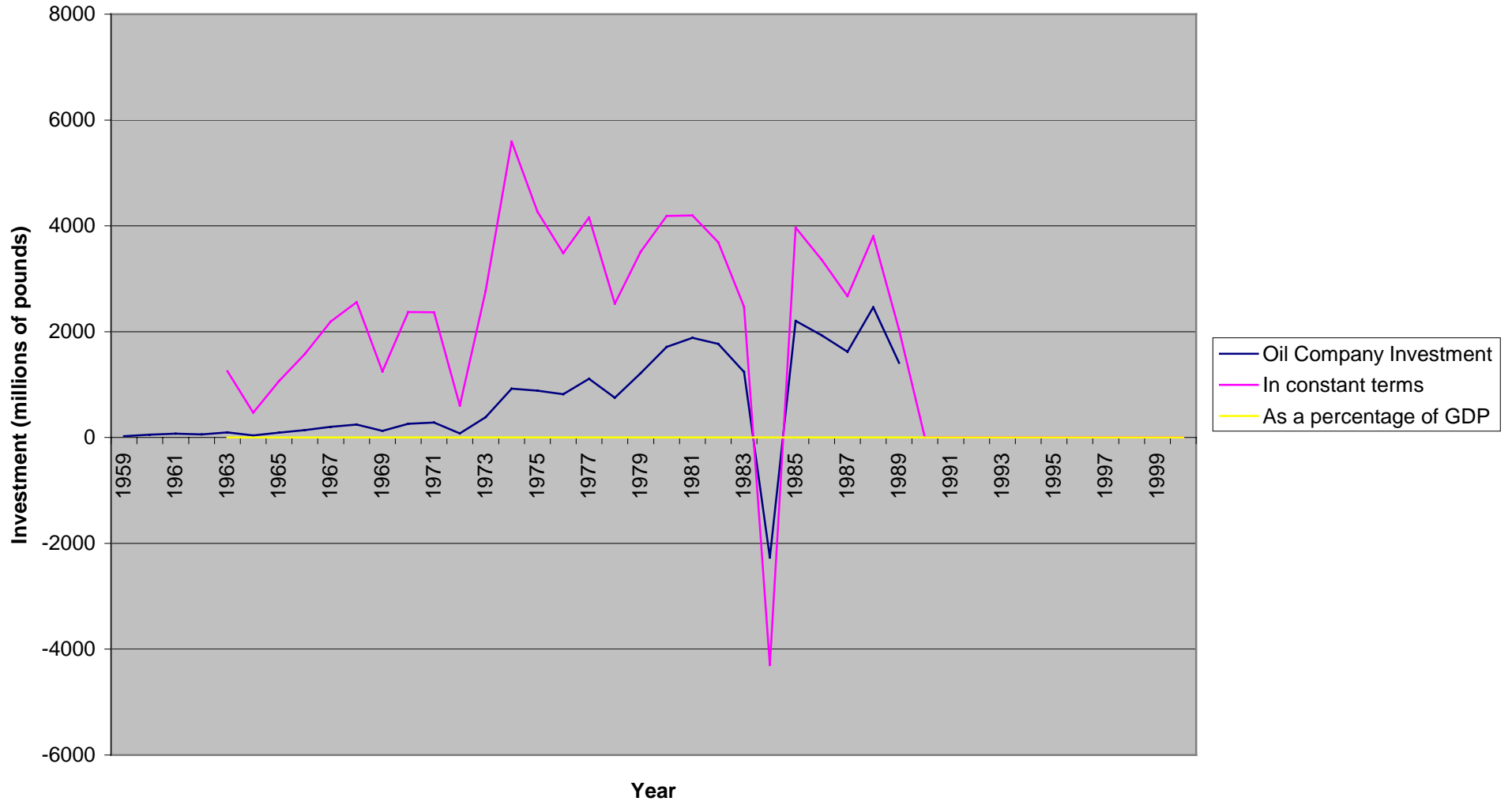


Chart 13, Total Portfolio Investment

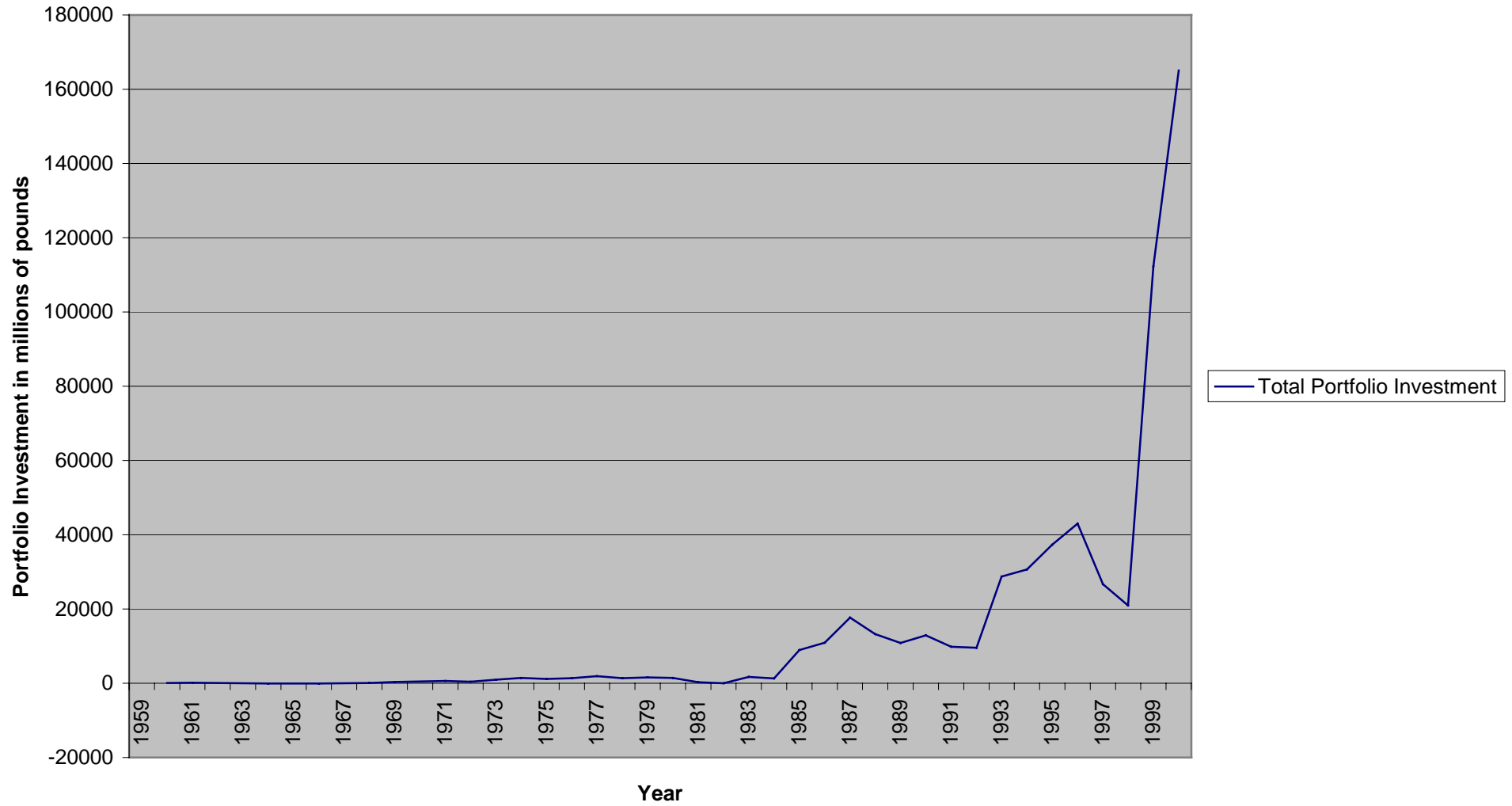


Chart 14, FDI and Portfolio Investment, Nominal Terms

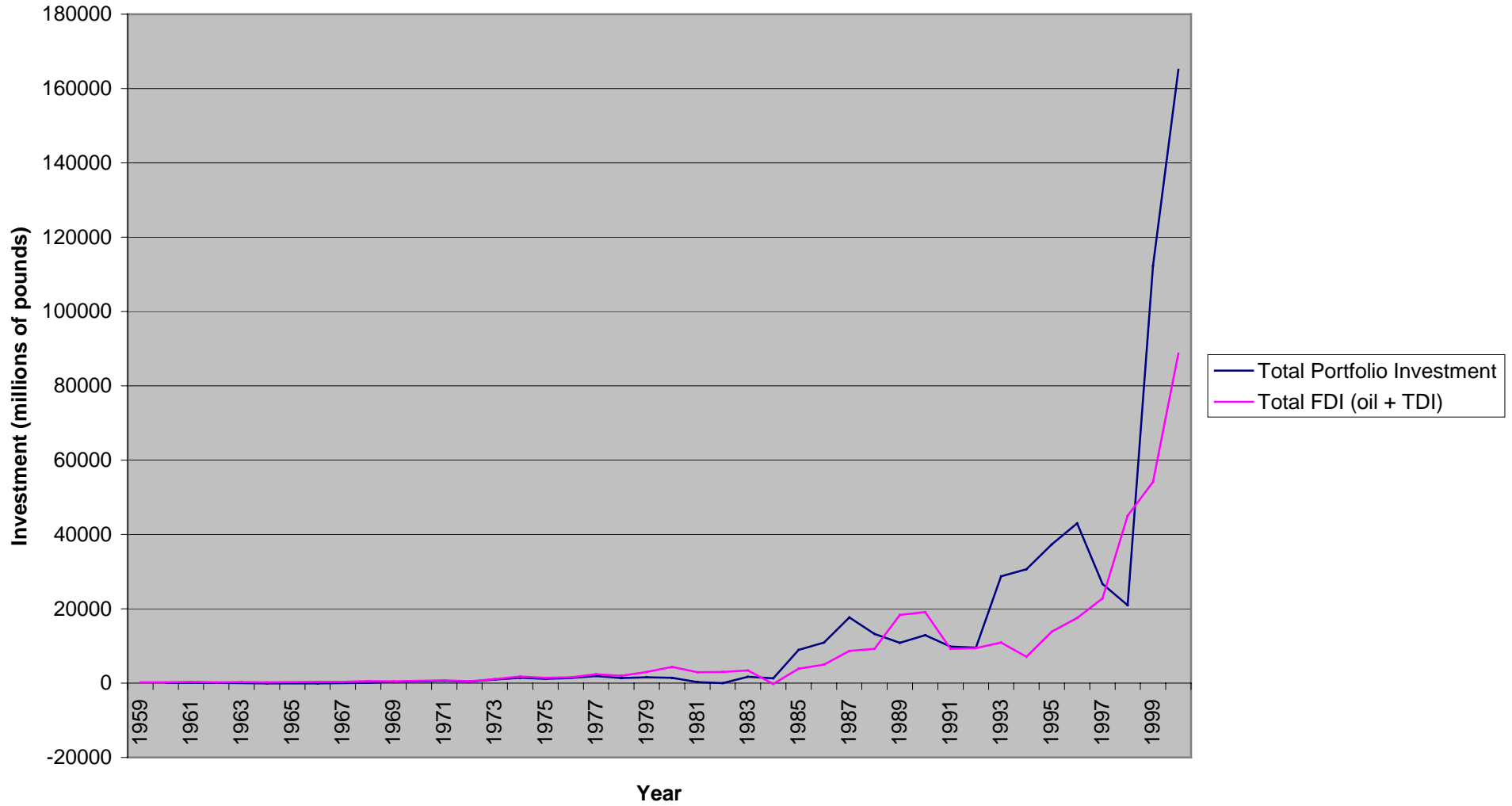


Chart 15, Oil and FDI as proportion of GDP

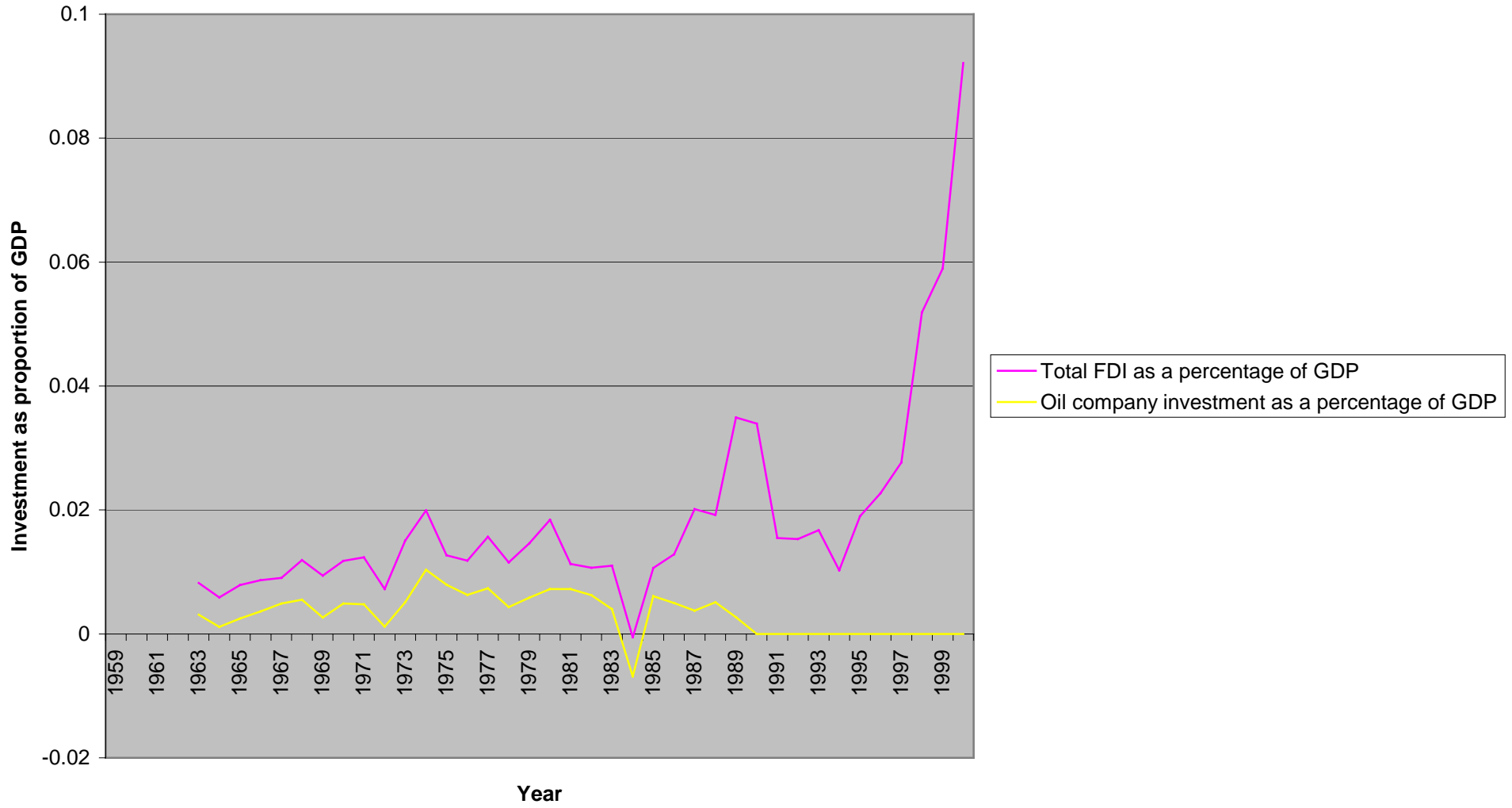
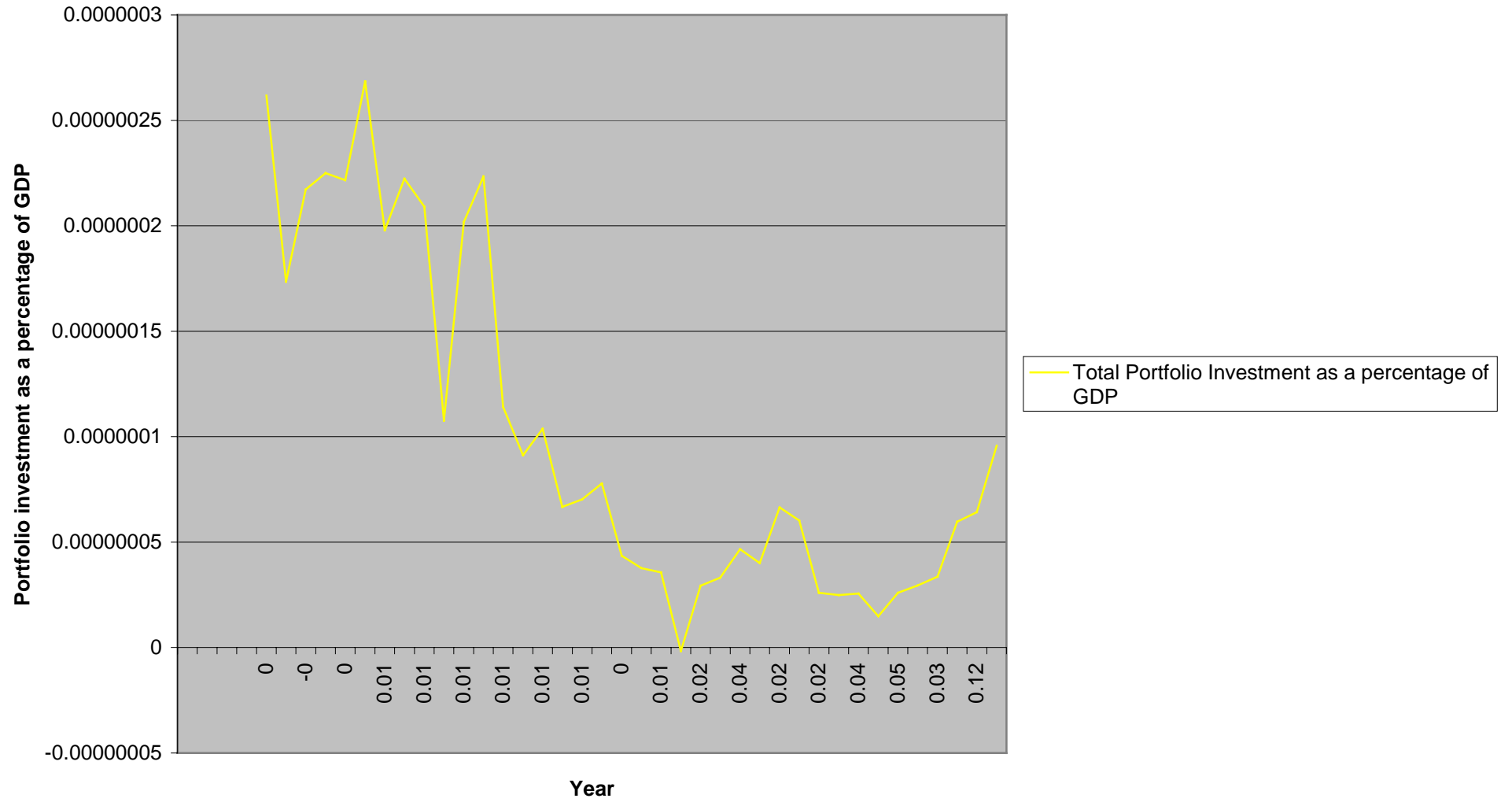


Chart 16, Total Portfolio Investment as a percentage of GDP



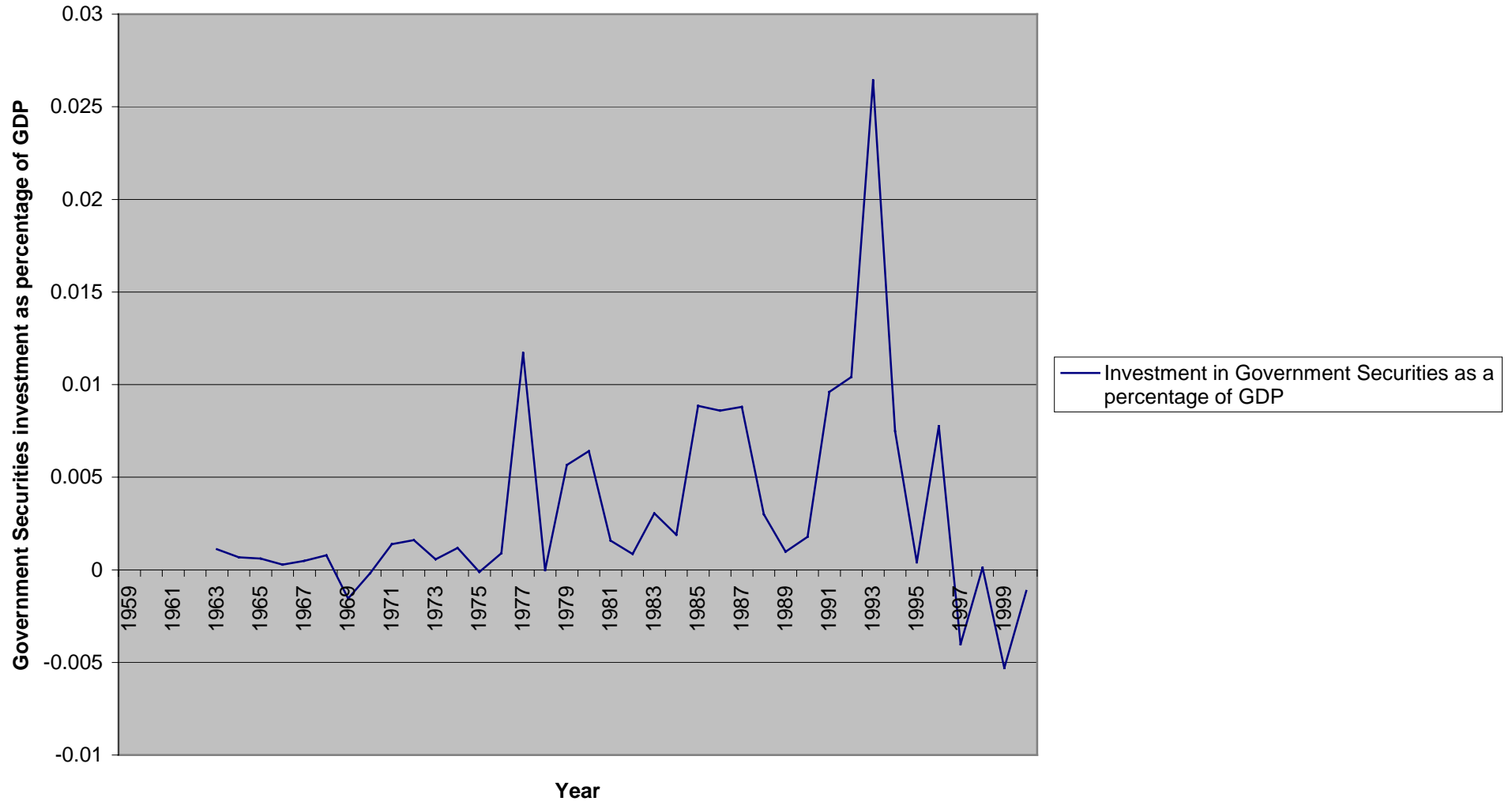
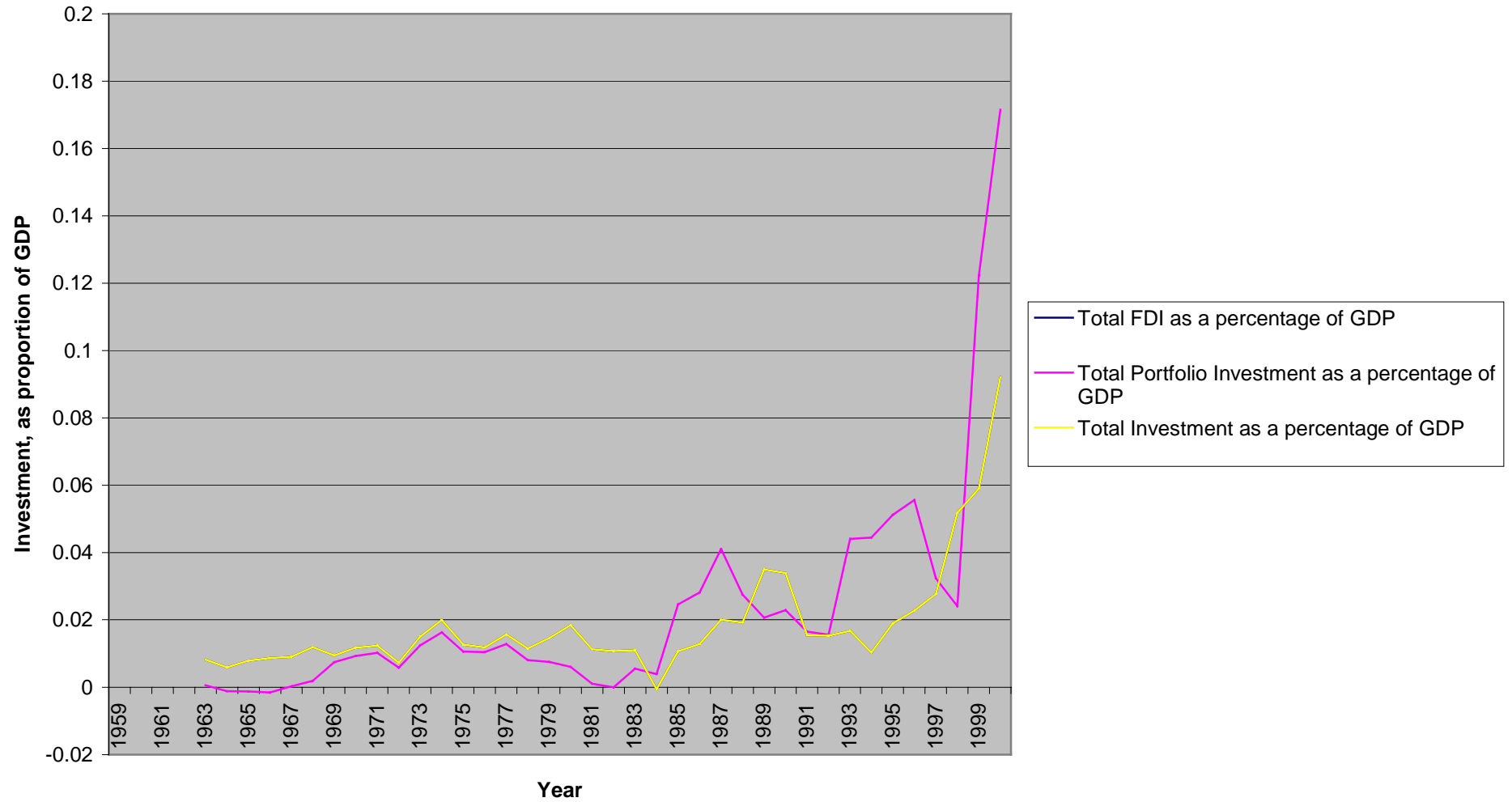
**Chart 17, Investment in Government Securities as a percentage of GDP**

Chart 18, Oil company investment as a percentage of GDP



Chart 19, Investments as percentage of GDP





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**Table One – Foreign Investment in the UK, Yearly Data**

<b>Year</b>	<b>FDI (£ million)</b>	<b>Portfolio (£ million)</b>	<b>Total (£ million)</b>
1959	172		172
1960	190	43	233
1961	311	115	426
1962	187	61	248
1963	257	19	276
1964	200	-39	161
1965	288	-46	242
1966	335	-58	277
1967	370	11	381
1968	528	87	615
1969	448	354	802
1970	622	491	1113
1971	732	603	1335
1972	486	390	876
1973	1126	927	2053
1974	1778	1450	3228
1975	1410	1172	2582
1976	1537	1352	2889
1977	2367	1931	4298
1978	1991	1399	3390
1979	3030	1549	4579
1980	4355	1431	5786
1981	2932	257	3189
1982	3027	-11	3016
1983	3386	1701	5087
1984	-181	1288	1107
1985	3865	8913	12778
1986	4987	10911	15898
1987	8681	17710	26391
1988	9218	13220	22438
1989	18344	10860	29204
1990	19132	12880	32012
1991	9197	9818	19015
1992	9416	9579	18995
1993	10943	28770	39713
1994	7099	30680	37779
1995	13831	37315	51146
1996	17562	42985	60547
1997	22823	26670	49493
1998	45054	20926	65980
1999	54131	112274	166405
2000	88622	165045	253707

Source: ONS Pink books

**Table Two – GDP in the UK, Yearly Data**

<b>Year</b>	<b>GDP (£ million)</b>
1963	31133
1964	33951
1965	36411
1966	38584
1967	40858
1968	44352
1969	47583
1970	52884
1971	59162
1972	67167
1973	74707
1974	89215
1975	111136
1976	129789
1977	151058
1978	172784
1979	207612
1980	236486
1981	259454
1982	283439
1983	308073
1984	330697
1985	362814
1986	388133
1987	431244
1988	479982
1989	525141
1990	563735
1991	595054
1992	615404
1993	653582
1994	690575
1995	729001
1996	772856
1997	824164
1998	868642
1999	918202
2000	962130

Source: HM Treasury

### General Election Dates, Governments and Majorities since 1945

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