
Chapter 1

The UK economy in context

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Summary

One has to see the UK economy in context: there is the historical context and the international context.

The United Kingdom is a wealthy country with a high standard of living. The economy grew throughout the nineteenth century when the country experienced a rapid industrialization. It continued to grow in the twentieth century while becoming more of a service economy: employment in industry fell while numbers working in health, education, leisure, and finance grew.

At the world level the second half of the twentieth century was marked by a steady globalization of the world economy as trade and foreign investment expanded rapidly. Efforts to promote economic development achieved mixed results. South-East Asia was the outstanding success story and a number of countries there have raised output and living standards dramatically. In the Indian sub-continent and in Latin America there has been economic progress but there remain huge disparities in living standards and many remain in poverty. In Africa the picture, with some exceptions, continues to be bleak.

1.1 Introduction

To begin to understand the UK economy one has to see it in context. There is the historical context: all economic activity takes place in historical time and how an economy has developed in the past will influence its structure and its productive capacity today. Then there is the international context: the UK is dependent on other countries; it trades extensively with them, its companies invest abroad, and it receives inward investment from abroad. The UK is part of the EU and a member of many international bodies such as the WTO and the IMF. And there is a constant movement of people, money, and ideas across frontiers.

In what follows, we look first at the main features of the present-day UK economy and at how these have evolved over time. We then look at some of the main groups of countries that compose the world economy and consider their recent evolution. Finally we discuss briefly some of the more important international economic organizations.

1.2 The UK economy: an overview

1.2.1 Population

At the time of the census in 2001 the population of the United Kingdom was estimated to be 58.8 million. Of this total, 49.1 million were resident in England, 5.1 million in Scotland, 2.9 million in Wales, and 1.7 million in Northern Ireland. The total population has been growing over time: since 1961 growth has averaged just less than 0.3 per cent per annum with the result that the population has grown by about six million over the period.

This increase has mainly been the result of two trends evident throughout the twentieth century. First, the birth rate has fallen: although there have been considerable short-run fluctuations in the number of live births the trend has been downward. Counterbalancing this has been the fact that people have been living longer and, in recent years, net immigration has grown significantly. In the 1960s and 1970s there had been net emigration but by the 1980s there was an average annual net immigration of over 40,000 and this figure had risen to over 150,000 by the turn of the century.

The combination of a declining birth rate and increasing longevity has meant a slow but steady ageing of the population. In 1961 less than 12 per cent of the population was aged 65 or over, by 2001 this figure had risen to nearly 16 per cent and is predicted to continue to rise. These trends, common to all developed countries, have clear implications for the cost of providing pensions and health care.

1.2.2 Income

The best single indicator of the standard of living of citizens of a country is income per capita. It is far from perfect (see Box 1.1) but if its limitations are understood it is the most suitable for many purposes. National income can be measured in a number of ways (see Chapter 4 below), but we confine ourselves here to just one: gross domestic product (GDP). This measures the gross value (i.e. before providing for depreciation of buildings, machinery, etc.) of all that is produced in a country; and since all that is produced must be owned by someone, this figure will, apart from small amounts of income paid to or received from foreign countries, be equal to national income. When this figure is divided by total population, we derive income per capita.

The estimate of GDP (at market prices) for the UK in 2002 was £1,043 billion. As the population was 58.8 million, it can be calculated that income per capita was just over £17,700. This does not mean that everyone received or should have received an income

Box 1.1 Measuring economic welfare

Economists would like to have an unambiguous measure of economic welfare but no such measure exists and as an approximation they usually use income. This seems reasonable; after all most people see themselves as 'better off' when their income rises. But there are a number of problems when we use average income to measure the welfare of whole groups of people, e.g. all the citizens of a country.

First, statisticians of national income cannot measure such things as the black economy, i.e. the undeclared activities of those who avoid paying taxes; they can only estimate the sums involved. Nor can they measure precisely changes in quality: e.g. if a new computer is put on sale at a higher price than the previous model, is this price inflation, or is it a better computer (=higher output), or is it some mixture of the two? Again one can only estimate.

Then there are things that are not measured at all: in this category come many household activities such as the preparation of food (which would be measured if it occurred in a restaurant), do-it-yourself activities, and gardening. Such things tend to be more important in developing countries where a significant part of many families' standard of living is often food they have produced for their own consumption. This means that published figures normally understate the share of developing countries in global production.

There are also problems of interpretation even when the statistics correctly measure income. Suppose two countries have identical average incomes and so appear to have the same standard of living; but now suppose that one country is a lawless place and its inhabitants spend much of their income on security devices, alarms, and high insurance premiums whereas the other country is largely law-abiding and its citizens spend much less on these items. Who has the higher standard of living? As another example, suppose that the citizens of one country are appalling car drivers and spend much more on medical costs and car repairs than the citizens of the other country. Who again has the higher standard of living?

What if one country is more productive and so produces its output with people working fewer hours per week than in the other country? Its citizens will enjoy more leisure and most people would see this as contributing to their welfare, but statistics of income alone will not show this.

Many would argue that things such as health and education are so important for human well-being that they should be accounted for explicitly. This is the idea behind the Human Development Index (HDI) which provides an indicator of welfare by combining measures of health (life expectancy), education (adult literacy and school enrolment), and average incomes. As can be seen in UNDP (2003) the resulting index correlates broadly with income per capita but not wholly: some countries with similar levels of average income have quite different scores on the HDI.

such as this; in practice the distribution of income is unequal. What it does mean is that the gross value of all that was produced in the UK during 2002 was equivalent to an income of approximately £17,700 for every person in the country.

This figure gives a general idea of the British standard of living to anyone aware of the current purchasing power of the pound, but it only provides a single piece of information relevant to one year. It would be more interesting if put in the context of (a) how British national income has grown over time and (b) how British national income compares with that of other countries.

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Table 1.1 National income: average growth rates

	1960–73	1974–82	1983–93	1994–2002
USA	4.0	1.7	3.3	3.3
Japan	9.6	3.4	3.6	1.2
Germany	4.3	1.6	2.7	1.5
France	5.4	2.6	1.9	2.3
Italy	5.2	2.7	2.0	1.9
United Kingdom	3.2	1.0	2.5	2.9
European Union	4.8	1.9	2.4	2.4

Notes: Figures for Germany prior to 1991 apply to the former West Germany. The European Union in all periods covers the 15 states that were members in year 2002.

Source: OECD, *Historical Statistics*, OECD, *Economic Outlook*, various issues.

To make comparisons over time, we have to allow for inflation. We are interested in growth of real income, not just growth in money income caused by rising prices. Over the half-century from 1952 to 2002, real national income, measured by GDP, grew at an average rate of 2.6 per cent per annum. Allowing for population growth, this means that income per capita rose by approximately 2.3 per cent per annum, sufficient to raise average income over the period to more than three times its original level and to transform living standards. It was during this period that the British became a nation of home-owners; they furnished their homes with TV sets, washing machines, hi-fi equipment, and personal computers; car ownership grew greatly and foreign holidays became common. Material life changed at a rate as fast as at any time in British history.

Growth of income has not been consistent: in the UK, as in all other developed countries, there have been both cyclical fluctuations and also changes of trend. Prior to the mid-1970s, the developed countries experienced a period of rapid growth of output, near full employment, and, for the most part, low inflation. This came to an end after 1973, when the developed world entered a period marked by large rises in the price of crude oil, high and volatile inflation, rising unemployment, and slower growth of output. After the early 1980s conditions improved and economic growth rose, although not to the rates that had been achieved in the earlier post-war decades. Table 1.1 shows average growth rates achieved by a number of developed countries and by the EU as a whole during four sub-periods. The salient economic features of this whole period are discussed further below.

1.2.3 The structure of the economy

The structure of the British economy has changed over time. Some of the broad changes can be seen from Table 1.2 which shows the share of national income produced by different sectors of the economy at ten-yearly intervals over the period 1961–2001. Agriculture, which already accounted for less than 4 per cent of the value of national output in 1961, now accounts for less than 1 per cent of national production. This reflects a long-standing trend and is not usually seen as cause for concern; but the fall in the share of manufacturing industry has been the subject of much comment and of some anxiety. ‘Manufacturing’

Table 1.2 The structure of the British economy, 1961–2001 (% shares in GDP)

	1961	1971	1981	1991	2001
Agriculture, forestry, and fishing	3.9	2.8	2.1	1.7	0.9
Manufacturing	33.8	31.0	24.1	20.7	16.8
Energy and water	5.5	4.4	10.3	5.2	4.5
Transport and communications	8.1	8.1	7.1	8.2	7.7
Construction	6.1	6.8	5.7	6.0	5.2
Distribution, hotels, and catering	11.4	10.5	12.1	14.0	14.9
Business services, finance, and property	6.4	7.2	11.0	16.0	20.7
Public administration and defence	5.5	6.9	7.2	6.6	4.6
Education, health, and social work	3.9	5.5	9.1	11.2	12.5
Other	15.4	16.9	11.4	10.3	12.3

Source: NIBB, various editions.

is a broad category of output covering production of textiles, wood and metal products, paper, plastics, rubber, electricals, vehicles, machinery and equipment, and a host of other produced goods. It was the mechanized production of such goods which created industrial societies and enabled the great rise in living standards that occurred in the nineteenth and twentieth centuries. It is perhaps unsurprising that ‘de-industrialization’ should have been seen by many as a sign of economic weakness.

But it is important to be clear about the facts. The value of manufacturing output in Britain has for most of the last half-century continued to rise, albeit slowly: it is the share of manufacturing in total output which has declined, not the absolute amount. And the phenomenon is common to all developed countries and many developing countries as well: according to the World Bank services now accounts for two-thirds of global output.

If this trend is general, how should one account for it? The dominant reason would seem to be that people have a high income-elasticity of demand for services; as they get richer the pattern of demand shifts in favour of things such as education, health, leisure activities, financial services, and the ownership of residential property. In Table 1.2 one may note the steady rise in the share of national output accounted for by the sectors of (a) education and health and (b) business services, finance, and property.

One reason often cited for the slow growth of manufacturing output is competition from the newly industrialized countries of South-East Asia. There is probably some truth in this, but its importance should not be exaggerated. Production in South-East Asia has risen greatly but so also has the region’s demand for goods and services. The countries of the region export manufactured goods but they also import manufactured goods. And as yet the share of their produce in the imports of developed countries remains low. Most of the trade of developed countries is conducted with other developed countries.

Before we leave this topic it is worth noting that the manufacturing sector is not the only industrial sector of the economy. The category ‘energy and water supply’ covers the industries supplying oil, gas, coal, and water. Over the years the importance of oil and gas has grown and that of coal has shrunk.

It is clear that the British economy is, like most others, now largely a service economy. These changes in output have been reflected in changes in employment.

1.2.4 Employment

Table 1.3 shows the growth of the workforce in the UK over the last century. The figures cover all those working or actively seeking work. Given the size and heterogeneity of the workforce the compilation of accurate statistics is difficult and, in addition, there have been changes over time in how the statistics are presented: the numbers should therefore be treated as approximations rather than precise figures. Nevertheless the trend is clear: the total workforce has risen from below 18 million at the start of the twentieth century to nearly 30 million in 2002. The latter figure can be broken down into employees (over 24 million), the self-employed (over 3 million), and the unemployed (around 1.5 million).

In the first half of the twentieth century, growth in the working population largely reflected growth in the total population; in the second half, it has been caused principally by the increase in the number of women working or seeking work. This has more than offset a decline in male activity rates.

Until the 1960s, virtually all males between the ages of 16 and 65 were economically active, either working or seeking work. But by the late 1990s, less than 80 per cent were in the labour force, with many staying longer in education and many taking early retirement. In 2002 only 72 per cent of men over the age of 50 were still in work. Meanwhile more and more women have joined the labour force. In 1950 less than half of all women worked: by the year 2002 about 73 per cent of all women between the ages of 16 and 60 were economically active.

These trends, which are discussed in greater detail in Chapter 10, are common to other developed economies. For the EU as a whole, the activity rate for men aged 15–64 fell from over 95 per cent in 1960 to 72 per cent in 2000. For women the corresponding figure rose from around 40 per cent to 54 per cent.

Table 1.3 Total workforce in the UK (millions)

1900	17.74
1910	20.08
1920	20.76
1930	20.30
1940	21.91
1950	23.55
1960	24.51
1970	25.31
1980	26.84
1990	28.35
2002	29.18

Notes: Figures for the years 1900–40 exclude those employed in the armed services. All figures cover the employed, the self-employed, and those seeking employment.

Source: 1900–40: *The British Economy: Key Statistics 1900–1966*, Times Newspapers Ltd.; 1950–2002: *Labour Market Trends*, various issues.

Not only has the size and composition of the workforce changed, so has the pattern of activity. In 1950, in Britain, around 1.25 million people still worked in agriculture and over 8 million worked in manufacturing industry. By the early 2000s these figures had shrunk to less than 0.33 million and around 4 million respectively. The structure of employment is discussed further in Chapter 2.

1.2.5 Trade

Britain, like other countries, has long been a trading nation. In the years prior to the First World War (1914–18), exports and imports each amounted to some 25–33 per cent of national income. That war interrupted established trading patterns and the years that followed were marked by political and economic instability and by the growth of tariffs and other barriers to trade. By 1938 the share of exports in national income had fallen to around 16 per cent. But after the Second World War (1939–45), successive agreements negotiated under the auspices of the GATT substantially reduced tariffs. World trade grew, and with it, British exports and imports. By the mid-1970s exports once again accounted for around 25 per cent of national income and have since remained at or above this level. Within Europe, Germany, France, and Italy are similar to the UK in the importance of trade while among the smaller countries the share of foreign trade in national income is often well above 50 per cent. Table 1.4 shows the average share of exports in GDP for the two six-year periods ending in 1995 and 2001 for six European countries. Much of this trade is intra-European trade.

The composition of British trade in terms both of type of goods and services involved and of main trading partners has changed over time. In the early years of the twentieth century the pattern of trade that had been created during the Industrial Revolution was still apparent: Britain imported mainly foodstuffs and raw materials and exported manufactured goods, notably textiles.

By the end of the century there was no longer any difference in the broad categories of commodities imported and exported. Manufactured goods accounted for the bulk of all commodity trade in both directions and foodstuffs and raw materials (including oil) accounted for around one-sixth of both imports and exports. Services accounted for over

Table 1.4 Exports as a share of national income: six European countries (%)

	1990–5	1996–2001
France	21.5	26.2
Germany	25.1	30.1
Ireland	64.8	87.9
Italy	21.8	26.8
The Netherlands	56.9	62.2
UK	25.2	27.6

Notes: National income is measured by GDP.

Source: OECD: *Historical Statistics 1970–1999*, OECD: *National Accounts of OECD Countries 1990–2001*.

20 per cent of both exports and imports. There is further discussion of UK foreign trade in the next chapter and discussion of the balance of payments in Chapter 7.

1.3 The world economy: an overview

1.3.1 Introduction

The world economy has changed greatly during the past half-century and has become more integrated (see Box 1.2). Nor has change been confined to developed nations; there have been profound changes in the economies and societies of countries at all stages of development. Life expectancy in developing countries has increased greatly and average incomes have doubled. But progress has been uneven: some parts of the world are developing rapidly while others remain trapped in poverty. The World Bank estimates that over one billion people—nearly one-fifth of the population of the world—still live in extreme poverty.

Box 1.2 Globalization

Globalization is an ongoing process of greater interdependence among countries and their citizens. It involves increase in trade, in financial flows, and in movements of people. It is not new: the nineteenth century witnessed a great increase in cross-border movements of goods, finance, and people. Trade is estimated to have risen from less than 5 per cent of world output in 1820 to over 20 per cent in 1913. Two world wars and protectionism put the process into reverse but, after the Second World War, conscious policies of trade liberalization helped the figure to return to 20 per cent by the end of the twentieth century.

The advantages and disadvantages of globalization have become a subject of controversy. On the one hand, as argued cogently by Fischer (2003), there is now much evidence to suggest that participation in the world economy is good for economic growth, and without economic growth developing countries have little chance of reducing poverty. On the other hand critics of globalization argue that the trading system is biased against developing countries, chiefly but not solely on account of the extensive protection of agriculture by the USA, Europe, and Japan. Agriculture is the one area where many poor countries could export more if not artificially prevented from so doing. Critics also argue that the free movement of capital, including short-term movements, has caused instability for many developing countries.

But it is important to realize that the issue is not just whether a country is or is not part of the international economy. Institutional structures and political governance are also important: for example floating exchange rates are less likely to generate violent swings in capital flows; a sound fiscal position will not generate potentially destabilizing debts. Most countries, rich and poor, wish to be part of the global economy, and the evidence suggests they are right to do so. The problem for the world is not, Canute-like, to try to stop globalization but to try to make it work better, and especially so for the poorest countries.

But beyond broad generalizations, it is not easy to comprehend something as complex and diverse as the world economy. There are now more than 180 independent countries in the world as well as a number of territories such as Hong Kong or Puerto Rico which have a distinct economy without having political independence. Thus one can see the world economy as being composed of more than 200 distinct economies each with its own history and characteristics. In the richest countries annual per capita incomes exceed \$30,000 while in the poorest they are less than \$300.

Populations vary even more widely. China has an estimated population in excess of 1,200 million while there are over thirty countries with less than one million inhabitants. Total world population in 2001 was estimated to be 6.1 billion and is currently growing at around 75 million per year. Current projections suggest it will reach nine billion soon after 2050. A breakdown of world population by region is given in Table 1.5.

To begin to understand world economic development it is necessary to divide the world economy into a number of parts according to type of country, e.g. developed and underdeveloped nations, or on the basis of geography, or by a mixture of the two. As with all classifications, there is no one correct way; how one chooses to group countries depends upon what seems relevant for the subject under discussion.

The most basic distinction is between developed and developing nations and this is one frequently used. It reflects the important historical reality that a small group of countries, either European or settled by Europeans, developed new technologies and achieved high levels of output before most of the rest of the world had commenced its modern economic development. This group of countries was joined in the early twentieth century by Japan and, for a time at least, they did stand apart from other nations. But beyond these basic facts, simply dividing the world into two parts was always crude and often unhelpful and it has become less helpful as time has passed.

Table 1.5 World population by region, 2001 (millions)

Europe	731
European Union (25 members)	455
Russian Federation	145
USA and Canada	316
Latin America and the Caribbean	524
Asia excluding the Middle East	3,474
China	1,272
India	1,032
Japan	127
Middle East and North Africa	379
Sub-Saharan Africa	675
Oceania	31
Total	6,130

Note: For convenience the entire Russian population has been included in Europe.

Source: *World Bank Atlas* (2003).

Between the developed nations themselves there are big differences. Countries such as the USA, Switzerland, and the Scandinavian countries have long enjoyed high standards of living, the benefits of which were widely spread. Others such as Greece, Portugal, or the Republic of Ireland have until recent times had a more uneven development, with the affluence of modern sectors of the economy contrasting with the poverty of those in traditional sectors.

Among developing countries there have always been vast differences both between nations and between different sectors or areas within nations. Countries such as Argentina and Mexico experienced some early economic development and have always been best classified as middle-income countries. Others such as Hong Kong and Singapore have experienced rapid development in recent decades and their citizens now enjoy levels of income greater than those of many Europeans. At the other end of the scale there remain countries where there has been little change in the material conditions of life and where most inhabitants earn little and enjoy few of the benefits of modern life.

In what follows we provide a sketch of some of the main features of the world economy. It is inevitably no more than a sketch and, while we distinguish several groups of nations, one should not lose sight of the diversity of economic conditions between and within nations. In the wealthiest of nations there are usually areas of persistent poverty and in the poorest of nations there are always pockets of affluence.

1.3.2 The developed nations

We consider here those nations traditionally seen as developed countries. They comprise eighteen nations of Western Europe, the USA, Canada, Japan, Australia, and New Zealand. They are no longer the only rich nations and a number of other countries now enjoy similar standards of living, but they have traditionally been seen as a group of countries with certain common economic features and interests.

According to World Bank statistics, in 2001 these twenty-three countries produced nearly three-quarters of world output; the USA alone accounted for nearly one-third and Japan for a further 14 per cent. The United Kingdom produced just under 5 per cent of world output. It should be stressed that this refers mainly to marketed output and ignores much non-marketed output. (See Box 1.1.)

It was in these countries that modern economic development began. In Europe there had been a growth of new ideas and new technology over several centuries and this led, in the eighteenth century, first to a dramatic rise in agricultural output and then to the start of the industrial era. These ideas were quickly taken up in North America, in Australasia, and subsequently in Japan. By the start of the twentieth century much of northern Europe and North America was urbanized and economically developed. But two world wars in the space of thirty years cost Europe dearly in both human and material terms, and in 1945 much of its industry lay in ruin.

The settlement of the Second World War left Europe divided between a Soviet (Russian) controlled East under oppressive and ultimately inefficient regimes and a democratic West which, with the aid from America, began the process of reconstruction. This was rapid, and most of Western Europe regained its pre-war living standards within a decade. Economic

growth remained high during the 1960s (see Table 1.1 above); meanwhile Japan continued its dramatic post-war transformation into a great industrial power with annual growth rates of around 10 per cent. This era of widespread rapid economic growth came to an abrupt end in the mid-1970s: the problem was a combination of inflation and the price of crude oil.

In the post-war years inflation had been a serious problem only in a minority of countries; but inflation rates rose in the late 1960s and the problem was exacerbated by a worldwide boom which caused prices of raw materials to rise sharply. In 1973 the Organization of Petroleum Exporting Countries (OPEC), which then included twelve of the leading oil-producing nations, took the opportunity to act as a cartel and quadrupled the dollar price of crude oil. Six years later, after inflation had eroded the real value of this price, OPEC quadrupled it again. These actions had the seemingly paradoxical result of giving an added twist to price inflation while at the same time having a deflationary impact on world demand. Developed countries and non-oil developing nations alike had to devote larger amounts of resources to pay for a given volume of imports, while many of the oil exporters were unable to increase quickly their demand for the exports of other countries.

Unemployment rose but the need to deal with large balance of payments problems and high inflation meant governments were unable to take reflationary measures. Inflation rose to over 10 per cent per annum in many countries (see Table 1.6) and even exceeded 20 per cent in a few, of which Britain was one. Efforts to curb this resulted in a shift away from Keynesian policies to more monetarist-inspired ones. Targets for the growth of the money supply were introduced in many countries.

It became increasingly clear that inflation had serious disadvantages and few benefits. It also became clear that unchecked inflation would create self-fulfilling expectations of price rises which could only worsen the problem. After the second huge rise in the price of crude oil the authorities in most countries responded with drastic anti-inflationary measures. Monetary policy was tightened and interest rates rose sharply. This produced a severe recession and in 1982 output in the developed world as a whole showed an absolute fall for the only time since 1945. It also produced a disastrous situation for many developing nations, which saw the price of oil imports rising while both price and volume of exports declined as

Table 1.6 Inflation in seven developed countries (implicit price index for consumer expenditure)

	1963–73	1973–9	1979–89	1989–2002
United States	3.1	7.7	5.1	2.4
Japan	6.1	9.5	2.5	0.3
Germany ^a	3.4	4.6	2.8	2.2
France	4.8	10.9	7.2	1.8
United Kingdom	4.9	15.6	7.0	3.1
Italy	4.8	16.7	11.4	4.1
Canada	3.1	9.2	6.2	2.1

^a West Germany prior to 1990.

Source: OECD, *Historic Statistics*, 1970–99, and OECD, *Economic Outlook* (June 2003).

demand in the developed countries fell. In addition the interest burden on outstanding debts rose as most of these debts had variable interest rates linked to dollar interest rates in New York or London. This resulted in what became known as the international debt crisis, as one country after another announced its inability to meet its obligations and sought to reschedule its debts.

This time the anti-inflationary policies were effective and by 1986 average rates of inflation fell below 3 per cent for the first time in two decades. But if tolerance for inflation had fallen that for unemployment had risen. In most countries it remained throughout the 1980s more than twice as high as it had been two decades earlier.

Slower growth of output along with a gradual development of less fuel-intensive means of production and transport curbed the rising demand for oil. At the same time, high oil prices stimulated the development of new sources of supply, such as the North Sea and the Gulf of Mexico, and encouraged the development of alternative sources of energy such as nuclear power. The demand for oil from OPEC members declined and the power of OPEC to act as a cartel waned. In the mid-1980s the oil price collapsed and then remained at low levels until the late 1990s. In more recent years rising world demand coupled with supply problems in several producing countries have produced a rise in crude oil prices but these still remain, in real terms, far below the levels reached in the 1970s.

With the benefit of lower oil prices the developed economies experienced a cyclical boom in the late 1980s but inflation once more became a problem and there was a further period of deflation. But by the mid-1990s the developed world as a whole was again achieving steady growth of 2-3 per cent per annum, and this time with low inflation. There were, however, notable differences between countries. In North America there was a prolonged boom with rapidly rising output, falling unemployment, and low inflation, but across the Pacific it was a very different story. Japan had experienced a speculative boom in the 1980s when rapid growth in money and credit led to dramatic increases in prices of property and equity shares. In both cases prices reached unsustainable levels and when, in 1991, the inevitable fall occurred, many persons and firms made large losses. Bad debts rose and a number of banks became insolvent. Companies sought to reduce expenditure and investment fell in seven of the eleven years from 1992 to 2002. The government reacted with a series of fiscal stimuli, while monetary policy was eased to such an extent that short-term interest rates came close to zero. Despite this the economy remained stagnant with increases in output averaging no more than 1 per cent a year, unemployment rising, and, by the late 1990s, retail prices actually falling.

In Western Europe the position was mixed. Britain, Spain, Portugal, and the Scandinavian countries all experienced a long period of rising output and falling unemployment, but in France, Germany, and Italy output growth was low and unemployment did not begin to fall until near the end of the decade. A notable feature was the rise in output and living standards in the Republic of Ireland. After achieving high rates of growth in the 1980s Ireland saw an astonishing rise in output during the following decade: national income doubled and, by the year 2000, incomes in Ireland were on a par with those in the UK for the first time in modern history.

The world boom came to an abrupt end in 2001 and reduced orders for investment goods notably for computers and telephone equipment caused huge lay-offs in those industries. The drop in demand revealed a number of corporate scandals in the USA involving systematic

overstatement of profits, and this added to the climate of uncertainty and lack of confidence which further discouraged investment.

1.3.3 Eastern Europe and Russia

The collapse of communism and the opening up of hitherto closed economies enabled all to see how inefficient the former communist regimes had been. By dint of devoting large resources to areas of high priority, the former Soviet Union had created an impressive space programme and established a vast and powerful military machine but neither the Soviet Union nor its allies could provide consumer goods in the quantity or quality common in the West. They were slow to learn new technologies and largely incapable of putting them into everyday practice throughout the economy. The environment was neglected with a wasteful use of energy and few effective controls on industrial pollution; the cities were shabby with old buildings in disrepair and new ones cramped and squalid.

The task after 1990 was to create modern economies with less spending on armaments and with privatized companies operating in markets instead of state-owned industries complying to a greater or lesser extent with the dictates of planners. Perhaps inevitably the costs of restructuring came through before the benefits, but there were sharp differences between countries. In the Central European nations of Poland, Hungary, the Czech Republic, and Slovenia there were rapid reforms; companies were privatized and financial systems restructured. Aided by inflows of foreign capital, these countries soon achieved a growth in output and rising standards of living.

In Russia and other former constituent parts of the old Soviet Union (Belarus, Moldova, the Ukraine) both political and economic reforms were initially half-hearted or badly managed, or both, and the consequences were hyper-inflation and a drastic fall in output leading to the impoverishment of much of the population. Throughout most of the former federation of Yugoslavia, war and civil unrest produced similar dismal results.

But by the early years of the new century, attempts at reform had become widespread and living standards were everywhere rising, albeit from low levels. In Central Europe average incomes were around one-half of those typical in Western Europe; in the ex-members of the old Soviet Union and in the Balkans incomes were often little above one-quarter of those enjoyed in Western Europe. Five former communist countries of Eastern Europe (the Czech Republic, Hungary, Poland, Slovenia, Slovakia) and three former member republics of the old Soviet Union (Estonia, Latvia, Lithuania) are among the ten countries that became new members of the EU on 1 May 2004.

1.3.4 Latin America

Latin America has always been a diverse region. Its countries vary greatly in size, in population, and in wealth. In Argentina average income is around \$9,000 per annum; in Bolivia it is around \$1,000 per annum. In Argentina and in parts of Brazil economic development began in the nineteenth century and there were expectations that South America would develop successfully as had North America. But it was not to be. Most of the countries have suffered from political instability, poor economic management, and periods of hyper-inflation; saving and investment have been low and growth of output has often barely kept up with growth in

population. Latin American countries have tended to rely too much on foreign capital, and this has resulted in inflows of funds in good times but rapid outflows and financial crises whenever the confidence of foreign investors has faltered.

The 1970s were good times: the oil-producing nations were depositing large sums of money with international banks which, in turn, were eager to lend. It was a period of inflation and real dollar interest rates were low or even negative. Most Latin American countries borrowed heavily and the region experienced rapid economic growth.

But, as described above, the developed world reacted to the second round of oil price rises with deflationary policies. Interest rates rose sharply and, as the bank loans had been arranged at floating rates of interest, Latin American countries along with other bank debtors saw massive increases in debt service charges. At the same time they faced higher prices for oil imports and, as the developed world went into recession, both falling demand and lower prices for exports of raw materials.

Almost all Latin American countries were unable to meet their financial obligations and had to renegotiate their debt and interest payments. No new commercial loans were forthcoming and the countries of the region had to turn to the IMF for loans, which were only granted on condition of macroeconomic reforms, notably higher taxes and lower government expenditure. The 1980s were a time of recession, falling living standards, and hardship for those on low incomes.

The 1980s were also a time of political reform: military governments were ousted and democratic institutions reinstated. The debt situation was ameliorated in various ways and most countries again began to see modest growth in incomes. Inflation continued to be a problem for most countries (see Table 1.7), but during the 1990s there were successful stabilization programmes and most countries ended the century with inflation rates below 20 per cent. Notwithstanding these successes, the economies of the region remain fragile and there were serious financial problems in Argentina (1989 and 2001), Mexico (1994–5), and Brazil (1998–9). (See Box 1.3.)

Table 1.7 Inflation in Latin America:
annual averages (%)

	1985–94	1995–2002
Argentina	268	3.0
Bolivia	104	5.5
Brazil	773	13.5
Chile	19	5.0
Colombia	25	13.9
Ecuador	0	1.2
Mexico	43	17.4
Peru	343	5.9
Uruguay	73	15.5
Venezuela	36	39.4

Note: Figures are for retail prices in earlier years, for a broader measure of consumer prices for later years.

Source: IMF *World Economic Outlook* (Apr. 2003).

Box 1.3 Financial crises

Recent years have seen a succession of economic crises which have raised doubts about the stability of an international economic system involving much trade and free movements of capital. These crises involved Mexico (1994), Korea, Thailand, Indonesia, Malaysia, the Philippines (1997), Brazil, Russia (1998), Turkey (2000), and Argentina (2001). While each country is different and each crisis had its own specific elements there were, nonetheless, many factors in common such that one can give a broad general picture of these crises.

In every case the country was seeking to maintain a fixed exchange rate while at the same time borrowing heavily abroad. In some cases (the South-East Asian countries) this was because of rapid domestic economic growth and private sector borrowing, in others it was because of large fiscal deficits and public sector borrowing. In most cases the domestic banking system was weak and official supervision inadequate.

Throughout much of the 1990s international banks were liquid and short-term loans freely available. It was common for the receiving banks to borrow dollars, convert them, and then make loans in the domestic currency, thereby creating the potential for losses if the domestic currency were to decline in value.

The situation was not a secure one. If foreign lenders grew worried about the ability of a borrowing country to service its debts they would first charge higher interest, then cease new lending, then seek to withdraw sums already lent, which they could do as most loans were short term. Very quickly the situation could turn to panic and the country would be unable to maintain the fixed parity. Once the currency was floated then markets typically overreacted and its value fell heavily. The Mexican peso fell by 50 per cent; the Turkish lira by about 45 per cent, and the Indonesian rupiah by an amazing 80 per cent. Prices of imported goods rose while many firms with foreign-currency debts became insolvent. Defaults on debts to banks just served to worsen the (in most cases) already fragile state of the banking system. Output and living standards fell and unemployment rose. In Indonesia the fall in output was 13 per cent, in Argentina over 15 per cent.

Economists have sought to draw lessons from these crises but space precludes more than a brief mention of the main ones. The first is that for open economies a floating exchange rate (whether officially managed or a free-float) is less likely to encourage inflows of short-term funds vulnerable to panic withdrawals. An efficient and properly supervised financial system is a high priority. Fiscal policy should seek to avoid creating large public debts which cannot be financed from domestic savings.

Many Latin American countries continue to suffer from political instability and fiscal irresponsibility and, of the larger countries, only Chile has sustained a significant growth in real income in recent years. The United Nations Economic Commission for Latin America and the Caribbean reported in August 2003 that 'six lost years' of depreciating currencies, weakening global demand, and financial, political, and fiscal crises had combined to hold per capita GDP to 2 per cent below 1997 levels. In the Argentine, GDP per capita was still over 15 per cent below 1997 levels.

1.3.5 South-East Asia

After centuries of economic stagnation South-East Asia became, during the last fifty years, the most dynamic region of the world economy. Hong Kong, Singapore, South Korea, and

Table 1.8 Economic growth in South-East Asia: annual average growth of GNP per capita, 1990–2001, selected countries (%)

China	8.8
Hong Kong	2.1
Indonesia	2.3
Malaysia	3.9
Singapore	4.4
South Korea	4.7
Taiwan	4.2
Thailand	3.0
Vietnam	6.0

Source: World Bank Atlas (2003) and (for Taiwan) Maddison (2001).

Taiwan all achieved regular increases in output of 5 per cent–8 per cent per annum, enough to transform the lives of their citizens. In the 1970s Malaysia and Thailand also began to grow rapidly and the six countries became known as the newly industrialized countries (NICs) or more colourfully as the Asian tigers. Subsequently Indonesia, the Philippines, and China also began to see rapid economic progress (see Table 1.8).

Given that the population of China is over one-fifth of total world population, the transformation of that country is clearly of great significance in bringing about a reduction in world poverty. Thirty years ago average Chinese incomes (measured at exchange rates reflecting purchasing power parities) were less than \$1,000 per annum; today they are over \$4,000 per annum. Unlike Russia and the countries of Eastern Europe, China has not ceased to be ruled by a communist party, but it has introduced private property, a stock exchange, and a widespread use of market mechanisms as well as progressively opening the economy to international trade and foreign investment.

Rapid growth can have costs in terms of economic stability and years of high profits can lead both companies and financial institutions to behave imprudently. There had previously been a sharp recession affecting much of the region in the mid-1980s and another more serious recession occurred in the late 1990s. (See Box 1.3.)

1.3.6 The Indian sub-continent

The Indian sub-continent is dominated by the three countries India, Bangladesh, and Pakistan. All three figure among the ten most populous countries in the world and all are poor countries with average annual incomes below \$550. Agriculture still accounts for around one-quarter of national income with much output produced by small-scale farmers heavily dependent on the weather.

Traditionally, the economies of these countries have been seen as very bureaucratic, with extensive government controls domestically, and important tariff and non-tariff barriers externally. Indian foreign trade (as a share of national income) is less than half that of China and the stock of foreign investment in India less than one-tenth of that in China.

But recent years have seen measures of liberalization in all three countries, with reductions in trade protection, the cautious opening of the economies to foreign investment, reforms of the tax and financial systems, and some modest privatization programmes.

There have been some success stories: more adults are literate, India has seen the growth of modern IT and telecommunications sectors, and average per capita incomes are now growing at around 4 per cent per annum in India and 3 per cent per annum in Bangladesh. In Pakistan the economy has suffered from persistent political instability and growth remains low.

But in all three countries such progress as has been achieved has had most impact on the residents of the large cities. For hundreds of millions living in rural communities, while there have been some improvements in health and education, standards of living remain low.

1.3.7 The Middle East and North Africa

The economies of this region are diverse. In Saudi Arabia and a number of small neighbouring states there are relatively small populations and large oil reserves. These countries enjoy high standards of living but are dependent on the fortunes of the oil industry. From the mid-1980s to 1999 the real price of oil tended to fall, and in consequence, incomes in these countries stagnated or actually fell.

Many of the countries have suffered from one or more of the evils of war, political instability, and repressive government, and growth in living standards has been fitful and slow. Both Turkey and Egypt are populous states and both experienced some early industrialization. Turkey is well endowed with natural resources and, throughout the twentieth century, has made attempts to modernize its economy and society. It has a free trade agreement with the EU and hopes to become a full member. In Egypt living standards are lower but economic reform and large amounts of foreign aid have produced a notable growth in output in recent years.

1.3.8 Sub-Saharan Africa

Sub-Saharan Africa comprises the entire continent apart from the Arab-speaking countries along the Mediterranean coast. It is here that many of the poorest countries in the world are found, most having average incomes of less than \$2,000 per year (see Table 1.9). This is so even when local values are translated into US dollars at exchange rates reflecting relative living costs rather than market values. Many of the countries have few indigenous raw materials while those that have mineral resources or exportable commodities such as coffee or cocoa have seen prices fall for much of the last thirty years. But worse than this: incompetent and corrupt governments, political instability, and, in many cases, war or civil war have often prevented available resources from being exploited.

The most populous state, Nigeria, is an important oil exporter, but years of corrupt military government have meant that few benefits have accrued to the bulk of the population. In the Congo (Democratic Republic) the thirty-year rule of the late General Mobutu saw the systematic theft of state assets while the infrastructure of the country fell into disrepair and living standards collapsed. Around one-half of sub-Saharan African states have seen their economies contract over the last two decades. Agriculture productivity remains low and production is vulnerable to droughts; and to add to the many other problems, in the

Table 1.9 Average incomes in the twelve most populous states of sub-Saharan Africa

	US\$
Congo (Democratic Republic)	630
Côte d'Ivoire	1,400
Ethiopia	800
Ghana	2,170
Kenya	970
Madagascar	820
Mozambique	1050
Nigeria	790
South Africa	10,910
Sudan	1,750
Tanzania	520
Uganda	1,460

Notes: Figures are for 2001 and are estimates rather than precise known figures. The exchange rates used to translate national currencies to US dollars are 'purchasing-power parity' rates, i.e. they take into account the cost of living of each country.

Source: World Bank Atlas (2003).

southern part of the continent there is now the highest incidence of HIV in the world. Life expectancy is falling in a number of countries.

There are a few success stories. Botswana has managed to exploit its diamonds in a way that has raised the general standard of living (although Botswana is one of the countries now suffering from the AIDS pandemic) and Uganda, Ghana, and Mozambique (after the end of a civil war) have also seen worthwhile economic growth.

It is widely recognized that if Africa is to see a sustained and widespread improvement in living standards it will need, as well as foreign aid, a big improvement in standards of government: too much aid has been wasted due to corruption and inefficiency. At a summit meeting of African heads of state in Durban in 2002 it was agreed to create a New Partnership for Africa's Development (NEPAD). The aim is to have African countries cooperate to promote peace, good governance, and human rights across the continent. It is a step in the right direction but the words will need to be followed by actions if they are to have an impact on the poverty of so many of Africa's citizens.

1.4 The international economic agencies

A feature of the last half-century has been the continuing attempts at international economic cooperation organized and promoted by a number of international agencies.

Although a few such bodies were founded prior to the Second World War, most have their origins in the years immediately following that conflict.

The Second World War caused loss of life and material damage on an unprecedented scale. In the closing months of the war and in the years that followed, there were efforts to foster political and economic cooperation in the hope of making future such wars less likely. In the political sphere, the most notable achievement was the creation of the United Nations. In the economic sphere, the IMF and World Bank were established; the General Agreement on Tariffs and Trade was created; and the agency later to become the Organization for Economic Cooperation and Development was set up.

1.4.1 **The International Monetary Fund (IMF) and the World Bank**

Both the IMF and the World Bank were created at a conference at Bretton Woods, New Hampshire, in 1944. Both are based in Washington DC and both count over 170 nations as members.

The IMF is concerned primarily with the international financial system, the maintenance of orderly exchange rates, and (as a consequence of the latter) the macroeconomic policies of member countries. These countries pay a subscription to the Fund and are entitled to ask for loans in amounts related to the size of their subscription. These loans, for the most part, provide medium-term finance to assist countries to cope with balance of payment problems. Small loans are granted unconditionally but, for large loans, the Fund requires borrowers to adopt policies to restore the country to balance of payments equilibrium. This usually means a package of measures including devaluation of the currency and restrictive monetary and fiscal policies.

The original purpose of the World Bank was to finance post-war reconstruction but nowadays it lends to promote economic development. Funds are obtained from subscriptions by member countries and from issues of bonds on world financial markets. During the 1950s and 1960s the World Bank financed mainly large-scale projects such as power plant, dams, and transport infrastructure. This attracted criticism as such projects, although supported by the governments of the countries concerned, frequently involved considerable disruption to the lives of ordinary people. The Bank responded to its critics and now supports many simpler projects using 'intermediate technology'. It has increased lending for agriculture and rural development and for projects to improve education, health, and public hygiene. A high priority is now accorded to projects designed to alleviate poverty directly.

1.4.2 **The World Trade Organization**

As part of post-war efforts to promote better international relations, there was a desire to return to a more liberal trading order with fewer tariffs and other obstacles to trade. There were negotiations to establish an international trade organization and, as an interim measure, twenty-three countries signed the General Agreement on Tariffs and Trade (GATT) and set up a small secretariat in Geneva to administer this. The negotiations proved difficult and the project was eventually abandoned, but the GATT secretariat remained in place and over time grew to fill the role of world trade body.

The original GATT agreement pledged signatory countries to the expansion of multilateral trade and the reduction of tariffs and quotas. In furtherance of these objectives the GATT secretariat organized a number of trading rounds, i.e. international negotiations to agree tariff reductions, and these were successful in that many tariffs were abolished and others significantly reduced. Attempts were made to deal with non-tariff barriers in the Uruguay Round which lasted from 1986 to 1993. The discussions were complex but agreement was reached on a number of issues including reductions in agricultural protection and in barriers to trade in services such as banking and insurance.

The agreement also created a new World Trade Organization (WTO) as a successor body to the GATT. The new organization, which came into existence in January 1995, is designed as a body which will not only seek to further reduce artificial obstacles to trade but will also formulate rules in areas such as the environment, competition policy, and trade in services. Unlike the GATT, the WTO has a disputes procedure, and a number of trade disputes have already been submitted and judgements given.

1.4.3 **The Organization for Economic Cooperation and Development (OECD)**

The forerunner of the OECD was designed to assist the economic regeneration of Europe after the devastation caused by the Second World War. After the years of reconstruction the Organization evolved into a think-tank and research institute for the developed economies. Based in Paris, it provides a forum where representatives of member countries can meet and discuss issues of common interest. It also publishes a wide range of economic statistics as well as producing annual reports on the economies of member countries.

1.4.4 **Other international agencies**

There are many other international economic organizations, but space precludes more than brief mention of these. The International Labour Organization, based in Geneva, was founded in 1919 but is now affiliated to the United Nations: it aims to improve working conditions and to encourage the development of social security. The Food and Agricultural Organization, based in Rome, is a specialized UN agency concerned with improving efficiency in the production and distribution of agricultural, forestry, and fishing products. The Bank for International Settlements in Basel was established in 1929 to deal with reparation payments by Germany due under the Treaty of Versailles (1919), but now operates mainly as a think-tank and forum for discussions among central banks. It also carries out financial transactions on behalf of other international organizations.

Finally, there are a number of regional development banks such as the Asian Development Bank, the African Development Bank, and the Inter-American Bank. These institutions raise funds by taking subscriptions from member countries and by selling bonds to private investors. They use the funds raised to make loans for projects to promote economic development within their area. The latest such bank to be created is the European Bank for Reconstruction and Development, which provides finance and technical assistance to Russia and the former communist states of Eastern Europe.

1.5 Conclusion

The world economy has changed dramatically over the last fifty years. Tariffs and other obstacles to trade have been reduced while technology has made the movement of goods, of people, and of ideas easier and cheaper. The collapse of communism in Europe and its reform in China, along with a trend to economic liberalism elsewhere, have further promoted an open trading world economy. At the level of ideas there is now a consensus in favour of the mixed economy: private companies and markets, but also many ongoing functions for government. Against this background there has been remarkable economic development. In Britain and in other developed nations living standards have risen greatly but elsewhere there has also been rapid change. In South-East Asia, including China, output and incomes have grown. More recently the countries of the Indian sub-continent have begun to promote reforms and have seen improvements in living standards. Russia and the Eastern European nations have been grappling with huge transformations of their economies and, after initial and often drastic falls in living standards, most of these countries now appear to be achieving gains in output and incomes. Many areas of the world remain trapped in poverty, notably much of sub-Saharan Africa and parts of Central and South America, but the change and development of the last fifty years should make us hopeful about what can be achieved.

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Further reading

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A detailed macroeconomic approach to the UK economy written by a former Chief Economic Adviser to the government.

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D. H. Aldcroft, *The European Economy 1914–2000*, 4th edn., London: Routledge, 2001.

A clear economic history of Europe in the twentieth century.

A. Maddison, *The World Economy: A Millennial Perspective*, Paris: OECD, 2001.

For those who like a long-run perspective: this monumental work looks at the development of the world economy over the last 1,000 years.

S. Fischer, 'Globalization and its Challenges', *American Economic Review*, 93/2 (2003).

A comprehensive survey of the issues by a former senior economist at the IMF.

Websites

www.statistics.gov.uk

The site provides on-line access to official statistics of the UK economy.

www.worldbank.org

www.imf.org

Both sites offer a wide range of information about developments in the world economy.

www.undp.org

This site provides much information on development issues.

Questions

What is meant by the concept of a standard of living? What are the difficulties in (a) measuring this within one country and (b) making comparisons of the standard of living of people in different countries?

Should the relative decline of manufacturing industry in the output of the UK economy be seen as a legitimate cause for concern?

To what extent was the series of financial crises in recent years the fault of the international financial system and to what extent was it the fault of the policies pursued by particular countries?

How far is globalization inevitable? What are the factors causing it?