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Economics Revision Focus: 2004

AS Economics

Trade Deficit and Current Account

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Revision Focus: Britain's Trade Deficit and the Current Account

AS Syllabus Specification

Candidates should understand that the current account comprises: trade in goods, trade in services, investment income and transfers. They should understand the meaning of a deficit and a surplus on current account.

A2 Economics Syllabus Specification

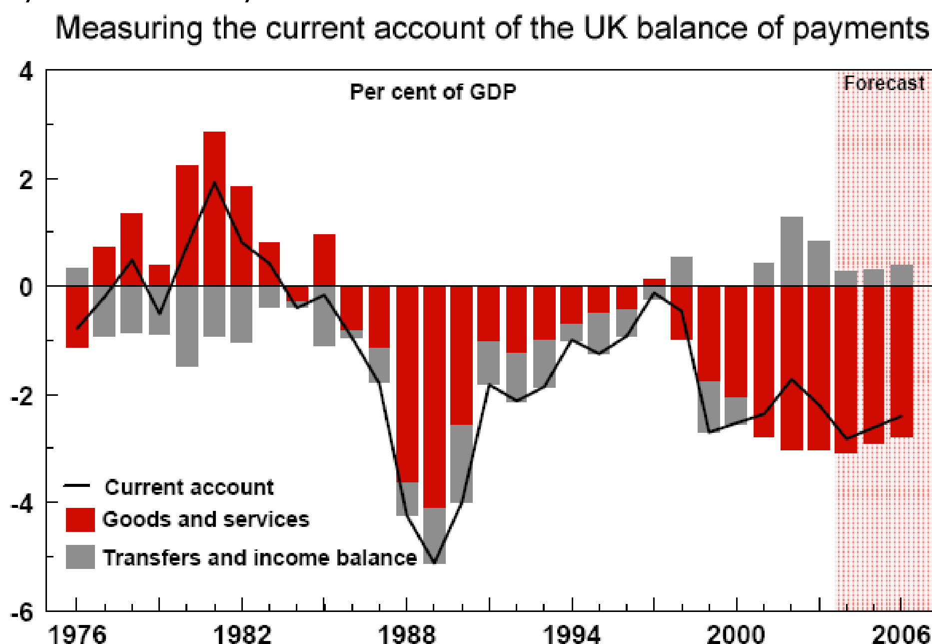
Candidates should know the difference between the current and capital account of the balance of payments.

Recent developments in the UK current account

The UK is now running the highest trade deficit in its history

- i The trade deficit in goods in 2002 and in 2003 exceeded £46 billion
- ii The trade surplus in services has come down from £15 billion in 2002 to £11 billion in 2003
- iii We run a strong surplus in net investment income (around £12 - £15 billion per year)
- iv Our transfers account is negative (around £6 - £8 billion a year)
- v Taken as a whole, the **current account** of the balance of payments was £20 billion in the red in 2003

The overall balance of trade in goods and services has deteriorated sharply over the last four or five years. It perhaps hasn't had the attention that it deserves from economists. The chart below tracks the main annual changes in the current account for the UK taken from the 2004 Budget speech. The figures for 2004 and beyond are Treasury forecasts



What are the main questions that concern economists regarding these figures?

i Why does the UK now run such large trade deficits in goods?
ii Does it matter if the economy is running persistent current account deficits?
iii Which policies are likely to be most effective in improving our trade balances in the years ahead?

The underlying causes of our trade deficit

It is useful to group the explanations for the record trade deficit in goods into short-term, medium-term and long-term factors. Some relate to the demand-side of the economy, others to supply-side economic influences

Short-term factors

i **Strong consumer demand** – real household spending has grown more quickly than the domestic economy can expand, leading to a very high level of demand for imported goods and services

ii Much of the evidence suggests that UK consumers have a **high income elasticity of demand** for overseas-produced goods – demand for imports grows very quickly when consumer demand is robst. Fawcett and Kitson in a recent article in the Guardian estimated that the income elasticity is around +2.3 suggesting that a 2% increase in real incomes boosts demand for imports by 4.6%. Because the overseas demand for UK exports rarely keeps pace with the surging demand for imported products, so the trade deficit widens when the economy enjoys a period of **consumption-led growth**.

iii The **strong sterling exchange rate** has helped to reduce the UK price of imports causing an expenditure-switching effect away from domestically produced output. In technical terms, the high pound has improved the **terms of trade** between the UK and other countries, allowing us to buy and consume more imports with each pound we earn.

iv **The weakness of the global economy** and in particular the very slow growth in the Euro Zone has damaged UK export growth. Nearly 60% of UK manufactured goods exports and over 50% of our exports of services are to fellow members of the European Union

Medium-term factors

i UK trade balances have been affected by **shifts in comparative advantage** in the international economy – for example the rapid growth of China as a source of exports of household goods and other countries in South-east Asia who have a cost advantage in exporting manufactured products
ii The availability of imports from other countries at a relatively lower price inevitably causes a **substitution effect** from British consumers.

Longer-term factors

i Much of our trade deficit is due to structural rather than cyclical factors – our average annual trade deficit in goods from 1992-2004 has been £16 billion

ii Our trade performance has been hindered by supply-side deficiencies which impact on the price and non-price competitiveness of British products in global markets - non-price competitiveness factors such as design and product quality are now more important for trade than merely price alone.

- A relatively low rate of capital investment compared to other industrialised countries
- The persistence of a productivity gap with our major competitors – measured by differences in GDP per person employed or per hour worked
- A relatively weak performance in terms of product innovation – linked to a low rate of business sector spending on research and development

iii The UK manufacturing sector has been in long-term decline for more than twenty years. Although we still have some world class manufacturing companies, the size of our manufacturing sector is not large enough both to meet consumer demand in the UK and also to export sufficient volumes of products to pay for a growing demand for imports

What does a current account deficit mean?

Running a sizeable deficit on the current account basically means that the UK economy is not paying its way in the global economy. There is a net outflow of demand and income from the circular flow of income and spending. The current account does not have to balance because the balance of payments also includes the capital account. The capital account tracks capital flows in and out of the UK. This includes portfolio capital flows (e.g. share transactions and the buying and selling of Government debt) and direct capital flows arising from foreign investment.

Does a current account deficit really matter?

Should we be concerned if, as an economy, we are running a large current account deficit? The UK has run large current account deficits in recent years with barely any effect on the overall performance of the economy. The United States economy is also experiencing a huge trade deficit at the moment. What are the implications of this?

In the 1950s, 60s and 70s, small balance of payments deficits in the UK caused 'economic crises' with periods of strong speculative selling of sterling on the foreign exchange markets and much political instability. The devaluation of the pound in 1967 led directly to the resignation of the then Chancellor, James Callaghan.

These days, trade deficits of enormous proportions seem to have little effect in global currency markets. Some policymakers and economists believe the balance of payments no longer matters because of **globalisation** and **financial liberalisation**: in other words, trade and current account deficits can be more easily financed by globally integrated capital markets freed from the capital controls that have been dismantled since the end of the 1970s.

This free movement of global financial capital has allowed countries, in principle, to increase their domestic investment beyond what could be financed by a country's own savings. Increasingly what we want to consume is produced abroad and if a country wants to operate with a sizeable current account deficit, then provided there is a **capital account surplus**, there is no fundamental economic constraint.

Britain has been a favoured venue for inward investment (an inflow of capital) and our relatively high interest rates compared to the USA and the Euro Zone has also attracted large-scale inflows of money into our banking systems. In this way the current account has been financed with little obvious economic pain.

So the main arguments for being relaxed about a current account deficit can be summarised as follows:

i **Partial auto-correction**: If some of the deficit is due to very strong consumer demand, the deficit will automatically partially-self correct when the economic cycle turns and there is a slowdown in spending

ii **Investment and the supply-side**: Some of the deficit may be due to increased imports of new capital and technology which will have a beneficial effect on productivity and competitiveness of producers in home and overseas markets

iii **Capital inflows balance the books**: Providing a country has a stable economy and credible economic policies, it should be possible for the current account deficit to be financed by inflows of capital without the need for a sharp jump in interest rates. The UK has run an average annual current account deficit of £10 billion from 1992-2004 and yet the economy has also enjoyed one of the longest sustained periods of growth and falling unemployment during that time

But

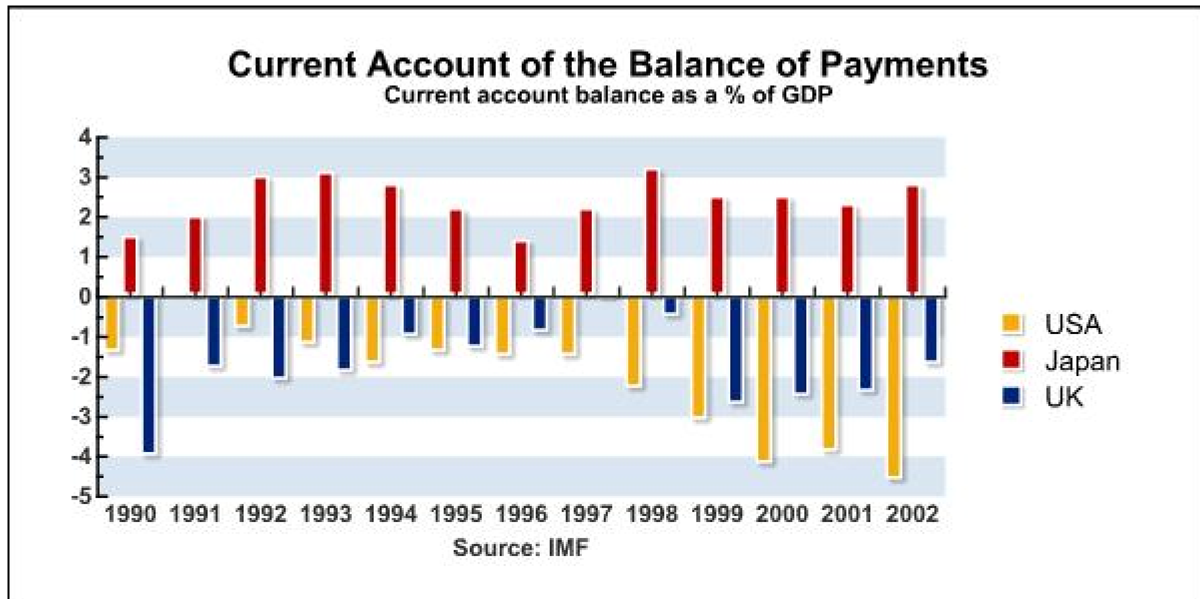
i **Structural weakness**: The trade / current account deficit may be a symptom of a wider structural economic problem i.e. a loss of competitiveness in overseas markets, insufficient investment in new capital or a shift in comparative advantage towards other countries.

ii **An unbalanced economy – too much consumption:** A large deficit in trade is a sign of an 'unbalanced economy' typically the consequences of a high level of consumer demand contrasted with a weaker industrial sector. Eventually these "macroeconomic imbalances" have to be addressed. Consumers cannot carry on spending beyond their means for the danger is that rising demand for imports will be accompanied by a surge in household debt.

iii **Potential loss of output and employment**: A widening trade deficit may result in lost output and employment because it represents a net leakage from the circular flow of income and spending. Workers who lose their jobs in export industries, or whose jobs are lost because of a rise in import penetration, may find it difficult to find new employment.

iv **Potential problems in financing a current account deficit:** Countries cannot always rely on inflows of financial capital into an economy to finance a current account deficit. Foreign investors may eventually take fright, lose confidence and take their money out. Or, they may require higher interest rates to persuade them to keep investing in an economy. Higher interest rates then have the effect of depressing domestic consumption and investment. The current situation in the United States is very interesting in this respect. Such is the size of the current account deficit that the USA must rely on huge capital inflows each year and eventually investors in other countries may decide to put their money elsewhere – this would put severe downward pressure on the US dollar (see below)

v **Downward pressure on the exchange rate:** A large deficit in trade in goods and services represents an excess supply of the currency in the foreign exchange market and can lead to a sharp fall in the exchange rate. This would then threaten an increase in imported inflation and might also cause a rise in interest rates from the central bank. A declining currency would help stimulate exports but the rise in inflation and interest rates would have a negative effect on demand, output and employment.



The chart above shows that the UK has run a current account deficit in each year since 1998 but that the size of the deficit expressed as a percentage of national income (GDP) has actually been falling in the last three years – it is now less than 2% of GDP – a manageable level with few obvious painful consequences.

In contrast the US economy is operating with a current account deficit on an enormous scale and this is part of the "twin deficit problem" that will have to be addressed in the near term (The US government is facing up to huge current account and budget deficit problems).