What explains the swings in the current account balance

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Introduction

The large and persistent shifts in the current-account balance of industrial and developing countries (DCs) in the first half of the nineties, as well as the balance-of-payments turbulence affecting emerging markets in the mid- and late nineties, have prompted renewed interest in the dynamics of the swings of current account balance(Selen Sarisoy-Guerin, 2005). As they noted, the swings in current-account balances are correlated with real depreciations in all economies-developed, developing and transitional but further analysis also shows that the effect of exchange-rate shocks as a factor or cause is stronger in the developed economies.

Evaluation of current account balance swings over time

The growing literature on swings of current account balance on the global perspective has produced various strands on the causes (Mendoza, Quadrini and Ríos-Rull 2009). One prominent school believes that the swings result from economic policy misalignments (Blanchard, Giavazzi and Sa 2005; Obstfeld and Rogoff 2005; Roubini and Setser 2005). Other approaches argue that the swings are caused by events such as differentials in productivity growth (Backus, Henriksen, Lambert and Telmer 2005; Caballero, Farhi and Gourinchas 2008; Engel and Rogers 2006; McGrattan and Prescott 2008), or business cycle volatility (Croke, Kamin and Leduc 2005; Fogli and Perri 2006), demographic dynamics (Attanasio, Kitao and Violante 2006; Henriksen 2005), a “ global savings glut” (Bernanke 2005), and the valuation effects (Cavallo and Tille 2006; Ghironi, Lee and Rebucci 2007; Gourinchas and Rey 2007; Hausmann and Sturzenegger 2006).

Depending on their perceptions of the source of is wings, three main positions have emerged in the literature on the adjustment (Little and Lafrance 2006). The optimistic view regards the global swings in current accounts balance as an equilibrium phenomenon resulting from responses of households and firms to a world of economic and financial integration that links nations ever closer (ibid). To them, the situation is not very alarming as the swings will self-correct themselves over time through interaction between technological, political, and market forces.

The pessimistic view claims that the swings are the manifestation of Americans on the comfortable path to destruction. Unwillingness or inability of surplus countries to stimulate domestic demand and deficit country to curb overspending increases the probability of a hard landing with catastrophic impacts (Zhichao, Frankie Chau and Na Shi, 2010). A third group takes the middle-ground in believing that, if proper measures are taken, orderly resolution of swings is achievable, but governments needs to remove distortions that thwart the market forces, which is hard to come by and so in an area for concern.

In the recent literature on international current account balance swings, there is a trend of using general equilibrium models to explain the dynamics of current account while still others believe that the traditional causes are still significant.

One important factor that has often led to current account balance swings is the concept of economic growth or consumer spending (Michael R. Pakko, 2000); a period of consumer led economic growth will cause a deterioration

in the current account as higher consumer spending will lead to higher spending on imports(ibid). At the end of the 1980s, the UK economy was booming with rising consumer spending and inflation this led to a widening deficit on the current account but the recession of 1992 led to an improvement and a brief surplus in the mid 1990s however, the recession of 2009 also led to a temporary improvement in the deficit as consumers cut back on spending causing a huge swing in current account balances (ibid). It should be noted that the economies characterised by export led growth such China will usually have a positive swing or surplus, on the other hand a country with a low savings rate and high % of consumption will typically have a higher current account deficit or negative swing overtime notably the United States of America.

Secondly exchange Rate fluctuations are one traditional cause of swings in current account balance. Depreciation in the exchange rate makes the currency relatively more competitive making exports more competitive and imports more expensive. This should improve the current account position and cause a positive swing however, whether the swing will be positive or negative depends of factors such as relatively price elasticity as explained by the Marshall Lerner condition which show a reflecting in the J Curve effect on how depreciation can worsen current account in short term and cause negative swings if demand is inelastic, but improves over time if demand becomes more elastic and therefore causing the current account balance to swing back(de Mello, L., P. C. Padoan and L. Rousová , 2010). In conclusion, current account balance swing can be negative or positive depending on the impact of the underlying factors.

Q. 4. Analyse the UK's balance of payments for a period of 10 years (data given in Tables 1 and 2). The analysis should include examinations (presentations of statistical data with discussion based on theory, journal articles, and examples from the market) of the current account balance and capital/financial account balance. Document the trends and investigate the causes.

Introduction

Balance of Payments records one nation's transactions with the rest of the world and includes the conventional flows of goods and services, cross-border payments associated with the international ownership of financial assets and current transfers, including remittances by workers from one country to another (Economic & Labour Review, 2009).

The UK balance of payments is a statistical statement designed to provide a systematic record of the UK's economic transactions with the rest of the world and is described as a system of consolidated accounts in which the accounting entity is the UK economy and the entries refer to economic transactions between residents of the UK and residents of the rest of the world (The Pink Book, 2010).

Hence in the BOP, sources of funds are usually recorded as positive and uses of funds recorded as negative. All things been equal the BOP sums to zero with no overall surplus or deficit but if a country is importing more than it exports, its trade balance will be in deficit, but the shortfall may be counter balanced in other ways – such as by funds earned from its foreign investments, by receiving loans from other countries.

Balance of payments statements cover a wide range of economic transactions which include exports and imports of goods, exports and imports of services, income flows, and financial flows, such as direct investment, investment in shares, debt securities, loans and deposits, transfers, which are offsetting entries to any one-sided transactions listed above.

The standard balance of payments classification comprises two main groups of accounts – the current account on one side and the capital and financial account.

Transactions classified to the current account include goods and services, income and current transfers. Within the capital and financial account, the capital account includes capital transfers and the net acquisition or disposal of non-produced, non-financial assets. The financial account includes transactions in financial assets and liabilities including reserves and gold.

UK Balance of Payment Trends

Current Accounts

The UK has recorded a current account deficit since 1984 and prior to 1984, the current account recorded a surplus in 1980 to 1983 and since the last surplus was recorded in 1983, there have been four main phases in the development of

the current account; the first phase, from 1984 to 1989, the current account deficit increased steadily until in 1989; during the second phase, from 1990 until 1997, the current account deficit declined to lowest in 1997 (The Pink

Book, 2010, 2009). From the Figure 1. 1 below, between 1998 and 2006, the current account deficit widened sharply, peaking in 2006. Trade in goods in goods has often been its biggest and most cyclical component part of the profile as shown by that pattern until 2001 but re-emerged in 2004 to 2006 with an increasing deficit on trade in goods being mirrored by an increase in the current account deficit (economic & labour review, 2009, the pink book, 2009, 2010). In 2007 and 2008, once more there was a change in direction of the movements of trade in goods to the movements in the overall current account balance. In 2009 however, the decrease in the trade in goods deficit once again broadly matched the fall in the current account deficit (Chamberlin G, 2009)).

Figure 1. 1: Current Accounts

USDs (Billions)

Trade in Goods and Services

The trade in goods account recorded net surpluses in the years 1980 to 1982, largely as a result of growth in exports of North Sea oil with the deficit growing significantly in the late 1980s to reach a peak in 1989, before narrowing in the 1990s(Whitaker S (2006). In Figure 1. 2 from 1998 the deficit jumped significantly and it has continued to rise till in 2008 before falling in 2009. Events in the financial sector may have affected business sentiments and investment decisions. It can be seen that trade was rising while the first signs of the financial crisis became apparent (The Pink Book, 2009) and this may be due to businesses exporting orders they had received

before the crisis. Trade peaked in July 2008 fell dramatically until 2009 (Chamberlin G, 2009, the pink book, 2009, 2010)

A surplus has been recorded for trade in services in every year since 1966 but there was a decrease in the surplus from 2008 to 2009. This may have been due to the impact of the mirroring of the financial meltdown hence the decrease in the surplus was largely dominated by a decrease in the financial services surplus, reflecting a fall in exports of FISIM by monetary financial institutions, and a decrease in the other business surplus(ibid)

Figure 1. 2 Trade in goods and Services

Credit less Debit – Billion (USDs)

Flow of Income

As indicated in figure 1. 3 the balance on income has been in surplus growing strongly between 2000 and 2002 and kept around this level until 2005 but fell in 2006, before increasing over the next three years till 2009. Movements in the income surplus from 2000 to 2007 have been largely due to movements in the net earnings on direct investment but in 2009 however, the increase on the surplus of income was mainly due to a reduction in the net earnings deficit on other investment (the Pink Book, 2009) and this more than offsets the reduction in the net earnings surplus on direct investment. Until 2001, earnings on both investment abroad and investment in the UK approximately doubled but in 2002 both fell sharply largely due to cuts in official interest rates and subsequent falls in interest receipts and payments on loans and deposits (ibid, Whitaker, 2006). From 2003 to 2007 income

increased significantly, and by 2007 both investment income credits and debits were approximately two and a half times the earnings seen in 2002(ibid). This reflected stronger profits on direct investment and a higher rate of return on both portfolio and other investment, together with significant levels of investment over the period (the Pink Book, 2009). In 2008 and 2009 income credits and debits both fell mostly due to lower earnings on direct investment while in 2009 the fall was mainly due to lower earnings on other investment as internationally interest rates continued to fall and the stock of other investment assets and liabilities fell by over 15 per cent (economic and labour review, 2009; the pink book, 2009, 2010).

Figure 1. 3. Income

USDs (Billions) – Credit less debit

UK Current Transfers

As clearly indicated in Figure 1. 4, the UK deficit for current transfers more than doubled between 1997 and 2000, growing from steadily but peaked slightly in 2000 after which the deficit increased again in each of the eight subsequent years until 2009 within 2007- the highest figure on record. The deficit on general government transfers widened in 2008 and continued steadily until in 2009 and over the same period the deficit for other sectors decreased drastically in 2008 but regained in 2009(The Pink Book, 2009, 2010)

Figure 1. 4. Current Transfer

USDs(Billions)

UK Financial Accounts

The impact of globalisation of the world economy explains why investment abroad and both into the UK increased in the mid-1990s but recorded net disinvestment as the global financial crisis deepened, leading to a reduction in loans internationally and a repatriation of deposits.

In 2005 and 2006, direct investment in the UK exceeded direct investment abroad however from 2007 to 2009, once again direct investment abroad exceeded direct investment in the UK hence within this three-year period, net outward direct investment had narrowed each year driven by a net outflow of reinvested earnings and other capital transactions and partially been offset by a net inflow of equity capital (The Pink Book, 209, 2010). In 2009 the net foreign direct investment outflow decreased from that recorded in 2008 primarily as a result of reduced reinvested earnings outflow, driven by a reduction in reinvested earnings abroad combined with an increase in reinvested earnings in the UK (Economic & Labour review, 2009, DFID, 2009).

In 2006 and 2007, due to the UK’s relatively high interest rate, the attractiveness of UK debt securities to foreign investors led to net inward portfolio investment in the UK and this position was maintained as the acceleration of the global financial crisis drove up demand for less risky long-term debt securities, even though interest rates had dropped considerably in the UK, while UK equity offered greater value for money to international investors as sterling depreciated (the pink Book, 2009, 2010) but in 2009

investors also returned to short-term debt issued by monetary financial institutions as confidence improved in the UK banking sector.

Direct investment

As seen in Figure 1. 5 outward direct investments initially peaked at USD350 in 2000, reflecting booming merger and acquisition activity. The largest outward acquisitions were the investment in Mannesmann AG by Vodafone Airtouch for a reported £100 billion and the purchase of Atlantic Richfield Company by BP Amoco Plc for a reported £18 billion (the Pink Book, 2010) but then declined in 2002 before recovering to a record level in 2007. As a result of the global recession, since 2007, direct investment abroad has decreased each year, reaching its lowest in 2009 due to lower investment in equity capital, lower reinvested earnings, and a switch from net outflows to net inflows of other capital.

Figure 1. 5. Direct Investment

USD (Billions)

On the other hand inward direct investment showed a pattern similar to outward investment with direct investment in the UK initially peaking in 2000, with investment followed by lower levels of investment. This may be due to the slowdown in global merger and acquisition activity (ibid). Inward direct investment fell in 2003, after which there was a considerable increase in the amount of inward acquisitions, including the purchase of Abbey National by Banco Santander in 2004, the Shell restructuring in 2005, and the purchase of Alliance Boots Plc by AB Acquisitions Ltd in 2007(the pink

Book, 2009, 2010). Throughout 2008 investment in the UK declined, and dropped considerably in 2009. This was due to lower investment in equity capital together with net outflows of other capital with some of the most significant acquisitions in 2009 included the acquisition of British Energy Group Plc by Electricité de France and Barclays Global Investors by Blackrock Inc(the pink book, 2009, 2010).

Portfolio investment

As indicated in figure 1. 6, there has been a net inflow of portfolio investment into the UK due to investment into the UK exceeding investment abroad with investments in debt generally exceeding investment in equities. In 2008 however, portfolio investment abroad showed net disinvestment as the global financial crisis deepened. The disinvestment was almost equally shared between equities and debt securities but 2009 portfolio investment abroad recovered strongly. The switch from net disinvestment to net investment for debt securities was mainly due to a reduction in disinvestment by UK monetary financial institutions and an increase in investment by UK securities dealers (the pink book, 2009, 2010).

Figure 1. 6. UK Portfolio Investments

USDs (Billions)

Investment flows, levels and income

Within portfolio investment, rates of return on debt securities have generally been higher than on equity securities (Economics & labour market Review, 2009). In Figure 1. 7 and beginning from 1998 to 2003 the difference in the

rate of returns generally narrowed before widening in more recent years and declining once again in 2008 and 2009. This was due to the rate of return on equity continuing to grow, while the rate of return on debt declined as interest rates fell in 2008, then both declined in 2009 explaining the similarities of return on other investment on debt in the early 1990s, but between then until 2004 they were generally in decline but from 2004 until 2007 they began to increase again, but started to declined in 2008 before dropping in 2009. Given that other investment constitutes approaching half of the value of the balance sheets, it is not surprising that the rates of return have reflected the movements in interest rates on loans and deposits such as the base rate and the London Interbank Offered Rate – LIBOR (DFID, 2011, the pink book, 2009. 2010)

Figure 1. 7 International position and income

Credit less debit

USDs

Conclusion

The Balance of Payments essentially records one nation’s transactions with the rest of the world – relating to conventional trade in goods and services, income flows and the transfer in ownership of fi nancial assets across borders. The International Investment Position, or net asset position, is the part of the Balance of Payments that records net stocks of the UK’s foreign assets and liabilities.

Q. 5. Is there any relationship between the UK balances of payments accounts and the exchange rate? Analyse and discuss

The relationships between balance of payments and exchange rate have been a subject of recent times. It is not surprising to learn that the study of exchange rate has been one of the most important areas of economic research over the past few decades. This body of research has experienced tremendous growth, especially in the post-Bretton Woods era in which foreign exchange rate has been highly volatile after the inception of the floating exchange rate regime in 1973 (Khim-Sen Liewa, Kian-Ping Limb and Huzaimi Hussain, 2008)

One of the areas of research that has drawn the attention of researchers is the exchange rate and trade balance relationship. The elasticity model of the balance of trade (Krueger, 1983) has shown the existence of a theoretical relationship between exchange rate and the trade balance. Empirically, various studies have been conducted to assess the influence of exchange rate on trade balance, with the objective of providing valuable inputs to policy makers on the effectiveness of exchange rate policy such as devaluation-based adjustment policies to balance a country's foreign trade (Greenwood, 1984; Himarios, 1989; Rose and Yellen, 1989; Bahmani-Oskooee, 1991; Mahdavi and Sohrabian, 1993; Rahman and Mustafa, 1996; Baharumshah, 2001; Bahmani-Oskooee, 2001; Lal and Lowinger, 2002; Singh, 2002).

In theory, nominal depreciation (appreciation) of exchange rate is assumed to change the real exchange rate (Himarios, 1989; Bahmani-Oskooee, 2001)

and thus has a direct effect on the trade balance. The UK balance of payment is no exception. Specifically, Bahmani-Oskooee (2001) noted that in an effort to gain international competitiveness and help to improve its trade balance, a country may adhere to devaluation or allow her currency to depreciate. Devaluation or depreciation increases exports by making exports relatively cheaper, and discourage imports by making imports relatively more expensive, thus improving trade balance. Hence a direct relationship exist between the two concepts.

Figure 1. 1. UK exchange rates patterns Figure 1. 2 UK Imports & Exports in USD (Billions)

However, many economists believe there is a short run phenomena dubbed the " J-curve" effect in the movement of trade balance, in which there will be an initial deterioration before a country's trade balance eventually improves reflecting the trough in 2008.

As the following chart shows, the trade deficit in goods has increased enormously in the last few years. After the UK had experienced a relative sterling devaluation from 1997 to 2008, the deficit rate of imports and exports had been increasing steadily and stable until end of 2005 when the sterling value went up and finally fell drastically in 2008 following financial crisis. This therefore saw an improvement in the UK exports. However, imports were increasing at an increasing rate due to the resilience of the UK economy to the crisis especially in the financial services sector. In conclusion, changes in the exchange rate can have a big effect on the balance of payments although these effects are subject to uncertain time

lags. When sterling is strong then UK exporters found it harder to sell their products overseas and it is cheaper for UK consumers to buy imported goods and services because the pound buys more foreign currency than it did before.