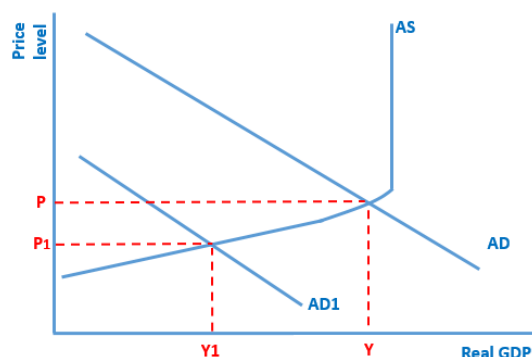


## Evaluate the possible microeconomic and macroeconomic effects on the UK economy of a widening current account deficit.

The *current account* of the balance of payments comprises the balance of trade in goods and services plus primary income (net investment incomes from overseas assets) and secondary income (net transfers). In the first quarter of 2016, the UK's deficit stood at 6.9% of gross domestic product (GDP), close to its record high. The UK has run a current account deficit since 1997 but it has started to widen exponentially since the Great Recession, significantly as a result of a move from surplus to deficit on the primary income balance.

*Accurate, detailed knowledge demonstrated on a topic that is often poorly understood by students.*



The UK's current account deficit is mostly a result of its massive trade deficit: its imports values are far greater than its exports values. The trade deficit is a component of AD and so it follows that AD should decrease as the trade deficit widens (to AD1 on the diagram). To put it another way, withdrawals from circular flow of income are greater than injections. As a result, UK jobs could be lost as consumers buy imports instead of domestic goods, as labour has a derived demand. Depending on changes to

other components of AD, the economy could be at risk of going into recession as real GDP falls to Y1.

*The language used here is extremely accurate – it is vital to refer to import and export **values** rather than **volumes** when looking at the size of the trade deficit and its impact on AD.*

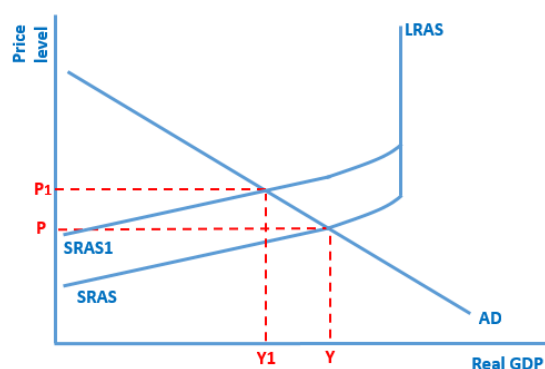
That said, the UK's trade balance only accounts for 5-8% of GDP; Consumption and Government Spending are far larger and more significant components. Therefore, however large the increase to the current account deficit is, it is unlikely to cause much harm to the overall performance of the economy: the numbers of jobs that are lost to falling demand will be relatively few, and real GDP is unlikely to fall in any noticeable way.

*This is a great example of how knowledge of UK economic data and patterns has enabled effective evaluation.*

The fact that the UK's current account deficit is so persistent (20 years +) is much more worrying than simply its size/increase because it implies that there are underlying structural weaknesses in the UK's economy. The UK, for example, actually runs a surplus in the trade for services; it is a world leader in industries such as finance, marketing, legal services and architecture. But it remains terribly uncompetitive in both primary and secondary sector industries. In the past 30 years, its manufacturing sector has shrunk by two-thirds. This is the key area responsible for dragging the current account down, and it forces the UK to be undesirably dependent on other countries for essential imports, especially goods such as raw materials, commodities, energy and food. This can have significant negative effects on low-income households, who will effectively be at the mercy of changing exchange rates and overseas inflation for purchasing necessities with price inelastic and income inelastic demand.

*This paragraph is crammed full of examples which show how to 'break down' a topic into smaller parts in order to develop a more detailed discussion i.e. consideration of different economic sectors, and consideration of low-income households (rather than consumers in general)*

*Good application to the UK economy.*



In addition, the UK's lack of exports put downwards pressure on its exchange rate. When the exchange rate depreciates, the UK is at a high risk of cost-push inflation since it buys in so many price-inelastic essential imports. This is shown in an AD/AS diagram by the SRAS curve shifting upwards and causing the price level to increase from P to P1. Such inflation is more worrying than demand-pull inflation because of the associated reduction in real GDP to Y1.

*Comparing the outcome under cost-push to demand-pull inflation is a simple but effective way of introducing a judgement*

Conversely, a current account deficit can sometimes be considered a sign of economic well-being, since it implies that demand for foreign capital goods (as industrialisation takes hold e.g. Latin America in the 1950s and 1960s) or foreign luxury goods (as GDP per capita rises) is increasing. But neither of those factors is particularly true in the current UK situation. The UK's industrial revolution is long gone – although arguably Brexit may result in a UK manufacturing revival - and the UK already has one of the highest GDP per capita rates in the world suggesting that growth in demand for foreign luxuries may have levelled out. Therefore, a widening current account deficit is certainly a macroeconomic concern.

*In this paragraph, combining a deep understanding of the various reasons for current account deficits with a sound knowledge of the UK economy allows the candidate to reach a supported judgement.*

The size of the current account deficit does mean, however, that its financing relies on continuing inflows of foreign direct investment on the financial account. According to the Bank of England, overseas companies account for roughly half of UK commercial real estate transactions since 2013; that is to say, foreign investors are buying more equity in UK based companies. This phenomenon has been clear to see for a while as many UK firms have gradually been sold to non-UK owners. For example, a large number of Premier League football teams are now owned by non-UK nationals, Cadbury's was taken over by Kraft (US) in 2009 and JLR was sold to Tata (Indian) in 2008.

*Good use of supportive data, followed by excellent examples.*

On the one hand, the UK economy could actually benefit from an increase of this sort. There could be an increase in the number of jobs available (since new, foreign firms are investing) and a greater level of technological and skill transfer – this could improve productive and dynamic efficiency, pushing down average costs and leading to lower prices/higher profits depending on the market structure of the industry concerned. On the other hand, foreign ownership can lead to a repatriation of profits (a leakage from the economy), companies relocating to other parts of the world (and the job losses that go with it) and redundancies (as new investors look for efficiency gains). On a micro level, the principal-agent problem due to significant divorce of ownership from control might be worsened, leading to misalignment of objectives and increased inefficiency.

*"On the one hand" is a useful connective phrase as it is usually followed shortly by "on the other hand", which allows evaluation to be built into the discussion.*

Despite the disadvantages, however, the fact that the UK's Financial Account is funded by FDI i.e. long-term capital, is more desirable than a situation in which it is funded by hot money inflows i.e. short-term capital, as in many Latin American economies. In this latter situation, banks find it difficult to 'recycle' such funds through lending because they can be withdrawn at very short notice as interest rates elsewhere in the world change. Therefore, the economy does not benefit from the money and investment levels are stagnant. What's more, the speculative inflows would hold the exchange rate above the competitive level which impacts on the level of job creation and prevents a correction of the current account deficit. In the UK, the inflow of FDI has been beneficial to many regions and industries, for example aiding previously inefficient businesses such as car-manufacturing to be more efficient and more able to compete internationally, which in turn supports local labour markets.

*The micro and macro impacts are neatly combined in this paragraph, and some sophisticated micro impacts have been deployed.*

In conclusion, the UK's current account deficit is a worry. It is not especially large but it is getting larger and it has been a persistent problem for over 20 years. The key reason for the deficit is the trade deficit in goods (there is actually a trade surplus in services!). And the Government would do well to try and solve this problem in the short-term – perhaps through supply-side policies or a fiscal boost for the manufacturing sector. Until this happens, the current account deficit is likely to continue and, as a consequence, foreign ownership of UK assets will increase. This has both potential advantages and disadvantages but, ultimately, is it better than hot money flows because of both the macroeconomic stability generated and the microeconomic impact on the efficiency of individual firms. One thing to be wary of in the near future, though, is the uncertainty surrounding the UK's economic outlook after Brexit. If foreigners decide to sell off those assets very quickly, the pound could plummet dramatically, and it would be difficult to sustain a continued current account deficit.

*This is a sophisticated point – many students don't understand the relationship between different components of the BOP.*

*Some attempt here to integrate the micro with the macro.*

*It is always useful to start a concluding paragraph with a clear judgement that is then supported.*

*Specific reference to microeconomic and macroeconomic effects is useful in a synoptic essay.*