Ignore the trade deficit at your peril

We save too little and invest too little. One symptom of this British disease is a persistent trade deficit, with imports continuing to outstrip export growth.

Britain's current account deficit consists of the trade deficit, offset by a surplus on invisible earnings such as insurance and banking. Although the City is a world leader, its invisible earnings are not large enough to fully offset the deficit on trade. During the Lawson boom the trade deficit deteriorated dramatically, soaring to a record £24.7 billion in 1989. In recent years, the trade deficit has shrunk, helped by the policy mix following sterling's ERM exit in 1992. Imports were held back by sluggish domestic demand as a result of tax increases. Sterling's depreciation improved competitiveness and helped exports.

Now the trade deficit is deteriorating again, reaching £11.6 billion last year and set to reach £15 billion this year. In January and February alone, the trade deficit reached £2.9 billion. Data released this Thursday may see the first-quarter deficit reach £3.9 billion, compared with only £1.9 billion at the same time last year. This is a big deterioration.

In the late 1980s it was common to hear people say the current account did not matter. This was wrong, but it was based on the following argument. Government borrowing and private-sector borrowing are identical to the deficit on the current account. So if the Government managed its finances and kept borrowing down then the current account would mainly reflect private sector behaviour. In the late 1980s the UK temporarily ran a budget surplus, thus the current account deficit was due to excess borrowing by the private sector, a large part of which was spent on imports. So, the argument went, as the trade deficit was a consequence of private sector behaviour it did not matter. After all, could the Government stop people from buying German cars or Japanese videos if they wished? No, but it could not ignore the consequences of a persistent trade and current account deficit.

In the past our growth potential has been limited by large trade deficits as the Government has often had to raise interest rates or taxes to curb import demand. This is less of a concern now. Indeed, the recent rise in imports is a safety valve for inflationary pressures, contributing to low inflation.

A current account deficit points to the UK running down its overseas assets and eventually borrowing from abroad, with sterling remaining a weak currency. The US experience since the 1980s highlights this problem. The country's large trade deficit has seen it move from being a net saver with overseas assets to a net borrower with large overseas liabilities. The US has become dependent on foreign capital inflows and the dollar has been weak. Just as we found in the UK at the time of sterling's ERM exit, foreign capital can leave a country just as quickly as it arrives. By contrast, the yen has remained a firm currency, helped by Japan's persistent surpluses on its current account, which have allowed Japan's overseas assets to climb to £476 billion.

Britain's stock of overseas assets climbed to £99.7 billion in 1986, but had disappeared completely by 1990.

Although there has been some recovery recently, with overseas assets reaching £17.7 billion in 1994, they could soon disappear if we were to experience a series of large trade deficits. While the UK may have no problem in funding its current account deficit, failure to tackle the problem can store up future problems.

Demand is clearly important. Much of the recent deterioration is due to weaker exports to the Continent. But the trade deficit is not just a consequence of the British economy growing at a faster rate than economies overseas. It also reflects underlying imbalances in the economy, as the UK has endured trade deficits even when the economy has grown slowly.

Price and quality are important. The UK has not always been competitive and it has not always produced goods of the right mix or product type because of the lack of previous investment. Thus exports to high-income economies have not always grown as much as exports from some of our competitors. And import penetration has been high, particularly when people have wanted to buy high-quality consumer goods.

For the UK to enjoy economic success it needs to create the environment in which the current account can improve. The solution is to have domestically orientated policies, aimed at improving competitiveness and the investment climate. On this front, policy has been partially successful. The UK has become an incredibly competitive economy but we are still some way from being a high-investment economy.

Last year, the average hourly labour cost in manufacturing was DM45.5 in Germany, DM29.04 in France and just DM20.96 in Britain, with only Ireland, Greece and Portugal lower in Europe. Sterling's post-ERM devaluation clearly boosted competitiveness. Despite this, an EU study at the end of last year showed that Britain has continued to lose market share within Europe.

Of course, low costs have been a key factor in attracting investment, which has improved job opportunities. In turn this is allowing the UK to overcome the investment problem, but we still have some way to go. We cannot be complacent and solely rely on inward investment. We need to raise the level and the quality of investment.

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Sunday 26th May 1996
Sunday Business

ECONOMICS WEEK

The trade deficit is growing at an alarming rate once more, reflecting underlying imbalances in the economy, warns **Gerard Lyons**