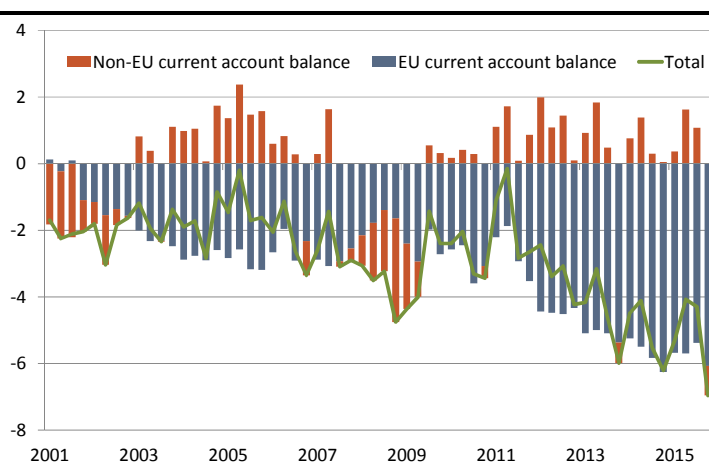


15 April 2016

Current account deficit: the UK's problem with Europe

UK current account % GDP



Source: ONS, Berenberg calculations

- The UK has been a serial debtor since 1998:** That was the last time the UK managed a current account surplus. In the decade before the financial crisis, strong economic growth and solid returns on foreign assets enabled the UK to sustain an overdraft with the rest of the world with little risk. The deficit improved briefly following the 2008 financial crisis after a rapid response by the Bank of England (BoE) sent trade-weighted sterling down 20%, making imports less attractive. Today's problem started in 2011. As our chart shows, the UK's current account deficit has widened in each year since. By Q4 2015, it had bulged to a record 7% of GDP.
- European sovereign debt crisis – the pivotal moment:** After a minor pause, the UK continued to grow apace after the sovereign debt crisis, while the Eurozone pursued a less aggressive monetary and a tighter fiscal policy during and after the crisis. Since 2011, UK goods imports from the EU have risen by 12% whereas exports have fallen by 22%. At the same time, income on the UK's EU assets slipped below what EU residents earned on their UK assets, adding an additional 2% on top of the growing goods deficit. Unfavourable exchange rate moves exacerbated the trend. Until the recent sharp drop on the back of Brexit uncertainty, the pound had been appreciating against the euro since early 2013. In 2015 Q4, sterling peaked at 1.43 against the euro, at which time the EU goods deficit reached a record 4.9% of UK nominal GDP.
- EU current account deficit is a risk not a refuge in a Brexit:** The out camp argue that the UK's EU trade deficit gives it the upper hand in Brexit divorce negotiations. That argument overlooks one crucial point. Whereas 15% of the UK's economy is linked to the EU via exports, less than 5% of EU-27 GDP is linked to the UK via its exports. The only time the deficit would be a factor in determining what happens if the UK voted out would be if markets panicked that the UK would no longer be able to finance the deficit. That could cause a sharp outflow of capital and a sterling crisis. It would be messy, and would have widespread economic and political consequences for the UK and the EU. It remains a remote prospect, but if the UK votes out, it is the risk to watch.
- Over time, a good chunk of the deficit should improve:** Now that the Eurozone has ended fiscal austerity and eased monetary policy aggressively, sterling is unlikely to appreciate significantly against the euro after weakening by more than 10% to 1.25 since December. This should boost the competitiveness of UK goods and services in the European market as well as reduce demand for imports, leading to an improvement in the trade balance. Likewise, as Europe continues recovering, UK residents should start to get a better return on their European assets. Over time, the current account deficit should begin to look a little less scary.
- A challenge for the BoE:** Even if the current account were to halve in size, it would still be large relative to the EU average. Ultimately, growth that is financed by too much selling of domestic assets and borrowed money from foreigners is unsustainable in the long run. It also presents a policy risk for the BoE, which has already cautioned that rate hikes could lead to reduced demand for UK exports if sterling appreciates as a result. However, rate hikes might actually contribute to an improvement in the current account, but that would depend on by how much rate hikes reduced domestic demand and caused imports to fall.

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