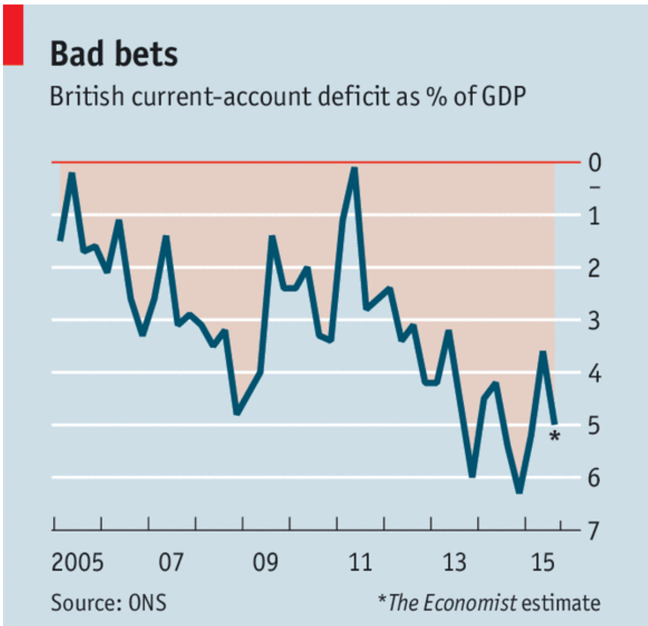
The Economist, October 17th, 2015

The other deficit

How worrying is Britain's large current-account deficit?

HEAR any politician talk of "the deficit", and he or she will now always be referring to the balance of tax revenues and public spending. The Conservatives boast of cutting the budget deficit from over 10% of GDP in 2010 to 5% now. But in the same period the current-account deficit, over which politicians obsessed in the 1960s but nobody any longer mentions, has yawned (see chart). Although it shrank in the second quarter, weak trade data suggest it will rise again in the third. No big developed country has a bigger current-account deficit as a share of GDP. In absolute terms Britain has the world's second-largest deficit, behind only America. Is this a problem?



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The current account is often misunderstood. It comprises three things. First, the difference between exports and imports of goods and services. Second, the gap between what British investors earn on foreign investments and what foreigners earn on their investments in Britain. And third, transfers such as money sent to and from Britain by migrant workers. In total it measures how much Britain is either lending to or borrowing from abroad.

Weak export performance is partly to blame for Britain's large deficit. In 2011 George Osborne, the chancellor, promised a "march of the makers" to rebalance the economy towards manufacturing exports. In fact, the volume of goods exports may be 10% lower this year than in 2011. However, disappointing net income from foreign investment is the main cause of the deterioration in the current account.

Britons have invested heavily in crisis-stricken Europe, with 9% of the country's foreign assets in France and 7% in the Netherlands. Yet much less has gone to countries that have stronger growth and thus offer higher returns. Less than 1% of British overseas assets are in China, and an even smaller share in India. On the other side of the equation, foreigners' investments in Britain have paid off handsomely, because Britain is now one of the fastest-growing countries in the rich world. This year dividend payments from British companies are expected to end up as much as 30% higher than they were in 2010, according to Capita Asset Services, a financial-services firm.

To finance its current-account deficit, Britain has sold assets to foreigners, from chocolate factories to posh London homes. It has also taken on more debt. Frugal sorts complain that Britain cannot pay its way in the world and that wealth is draining from the country. Others fret about the growing risk of a sharp and painful current-account adjustment as foreign investors withdraw support, of the kind Britain suffered in the 1960s and 1970s.

Yet a large current-account deficit is unlikely to prove as damaging as it once was. Past crises often came about because of failed attempts to support a currency peg. The pound now floats freely. If Britain's external deficit stays too large for too long, sterling will fall to help correct it. This would not be entirely painless. In the years following the global financial crisis, a much weaker pound pushed up inflation and crushed the real incomes of British householders. But such exchange-rate flexibility is the best defence against an abrupt funding crisis. In any case, the liabilities Britain has taken on to finance its recent current-account deficits are largely made up of equity and long-term debt, according to a paper from the Bank of England. Such capital is stickier than deposits or short-term debt, which can vanish in a trice.

Foreigners believe British assets are a good bet. Few economies with secure property rights and credible governance have decent growth. The euro-zone economy, for instance, may grow by no more than 1.5% this year. Japan is again flirting with recession. Britain is thus a favoured bolthole for skittish investors fleeing the trouble in emerging markets. Investors are more willing to finance a current-account deficit if the borrower's underlying wealth is solid. Net foreign assets, a measure of the value of assets owned abroad minus the value of domestic assets owned by foreigners, are worth around 35% of GDP, if foreign-direct investments are valued at current market prices, according to Ben Broadbent of the Bank of England.

The Brexit risk

In one way, though, Britain looks less solid. Its appeal to investors might diminish markedly if it looked like leaving the European Union. European investors hold most of Britain's short-term liabilities; plugging the current-account gap might become harder without a big fall in sterling, if sentiment soured on Britain.

The balance-of-payment risks from "Brexit" would be more manageable if the current-account deficit were smaller. Yet in the short term there is not much policymakers can do to reduce it. Public-spending cuts help to reduce the budget deficit, raising national saving. But with export markets weak, curbs on domestic demand might easily lead to job losses and dangerously low inflation. Mr Osborne wants to revive exports, but improvements might take years to come through.

Ideally the deficit would narrow gradually. A rising share of Britain’s trade deficit comprises capital goods, which should produce future returns that help to repay debts. Countries with rapidly ageing populations such as Germany (which holds one-tenth of Britain’s external liabilities) may start to draw down their foreign investments as people retire. Stronger growth in the rest of Europe would help the adjustment.

As long as foreigners continue to prize British assets, there is no reason why a current-account deficit at present levels cannot continue. Capital flows to countries that can make productive use of it. For now investors think the British economy fits the bill. But if that perception were suddenly to change, Britain might pay more anxious attention to its other deficit.