A discussion of the UKs current account deficit and its implications for the private citizen

Traditionally, Britain has been concerned with its BOP "problem", most clearly demonstrated by the "stop-go" cycles of the Bretton Wood era. The record CA deficit of the late 80's and the emergence of a BOT deficit in manufactures in the early 80's for the first time in British economic history has renewed interest on the subject.

During the last 2 or 3 decades, however, the importance and even the very existence of a BOP "problem" has been disputed : Free floating exchange rates, extensive international capital movements and a single currency have been proposed as ways to eliminate the BOP problem. More fundamentally, many people, including the ex-Chancellor N. Lawson, have argued that, provided the public sector is in equilibrium, CA deficits are not a problem at all since they simply represent optimising behaviour decisions of the private sector.

Intertemporal optimisation by economic agents and countries could well result in temporary but potentially protracted BOP disequilibria just as the life-cycle model for an individual agent suggests periods of saving (equivalent to a CA surplus) and dissaving (CA deficit). Examples may include Japan which because it has an ageing population, it may be building up international assets in order to use them for future consumption. Similarly, it could be argued that it may be efficient for Britain to smooth out its consumption from the unstable revenues from oil production by resorting to the international financial markets.

I believe that this theory has been very useful in dispelling the up to then prevalent view that every CA deficit is evil and has to be eliminated by government action as soon as possible. Nevertheless, this theory is often taken to extremes by arguing that every CA disequilibrium, caused by the private sector, is optimal and no policy response is needed. There are 2 main reasons why private optimising behaviour may not lead to socially optimum outcomes. The first refers to possible market failures, inefficiencies and even occasional irrationality of the financial markets (and of the private sector generally) which leads to all sorts of wasteful bubbles and subsequent crises. The debate about the efficiency of the financial system is too big to report here but one can have a healthy doubt of the private sector's optimal handling of its affairs.

Secondly, there are externalities which the private sector may ignore when making its decisions: The governments may have to concern themselves with longer term issues (though it is not entirely clear if the government should have a different time preference than its citizens!) and with macroeconomic considerations which may not adequately be taken into account by private agents. An obvious example is the exchange rate, since -

especially under a fixed ER regime- agents take the ER as given though their actions may lead to a depreciation and a subsequent fall in all the country's purchasing power.

The most important externality that the private sector may not take into account is that eventually, when the CA has to be balanced, a recession may then ensue. The view that the extensive international K movement has removed the need to balance the BOP is clearly wrong since this would require ever increasing interest rates. Similarly, the opposite view that the fact the BOP has eventually to balanced by itself disqualify the "optimal deficit" theory as some articles appear to suggest is also wrong. The BOP is a problem not because it simply has to be balanced at some point, but because the adjustment needed may conflict with other economic objectives. In particular we shall focus on the case of a CA deficit since there is much less pressure for surplus countries to adjust.

To see how this may happen we have to examine how can a CA deficit be reduced. Nominal expenditure will have to be reduced which may occur either by lowering domestic prices (and wages) or by reducing real output or of course a combination of the two. We can see two things here: first the impact of balancing the CA on the economy depends on our general views on how the economy functions. If we adopt a classical approach, the labour markets continually clear so balancing the CA will result in few if any problems. This means that there was no externality involved here and, ceteris paribus, the private sector's actions were optimal.

If, on the other hand, we adopt a Keynesian perspective reducing the BOP will lead to high unemployment. If the government tries to remove the deficit by exchange rate depreciation this is highly likely to lead to cost-push inflation as import and raw material prices rise, especially if the workers have real wage resistance. Inflation will (partly) erode the effects of devaluation so further devaluation is needed, potentially leading to an inflationary spiral. Similarly protectionism may lead to inflation as import prices rise while added problems of inefficiency and possible retaliation exist. Quite clearly in such a "Keynesian" world reducing a CA deficit can be painful and governments should probably try to stop the private sector from causing a BOP disequilibrium except if the gains from it are high enough (for example the deficit is due to high investment which may later endogenously eliminate the deficit as export production may rise).

The huge deficit of the UK of the late 80's has been attributed to the increase in household consumption as access to the financial system improved. In other words the recent increase in consumption and household indebtedness can be interpreted as optimal adjustments to the changes in the financial system. We can see that even if this was the case, the government had reason to worry about the CA deficit of the time as it resulted to the early 90's depression.

Up to now, we have been working in a static framework so that the trade off is between (nominal) income and external balance. Some economists, however,

most notably Thirlwall, have taken a dynamic approach and have argued that the conflict is between growth of income and external balance. The conclusions of the previous analysis regarding the desirability or not of private sector-caused CA deficits do not change: it still depends on whether the private sector has correctly estimated its own gains and losses and whether important negative externalities (including a possible recession) have been neglected. The implication of these dynamic theories is simply that his means that CA equilibrium here will not require a lower level of absolute income but a lower rate of growth of income.

Hence, if growth is mediocre and the country is running a big CA deficit, it should be a cause of worry because it means that the constrained (i.e. the long-run) growth of the country may be low. This is the case when the income elasticity of imports is greater than that of exports. Relatively low domestic inflation and/or continuous devaluations will relax the constraint but the deflationary costs of the former and the inflationary implications of the latter limit their effectiveness. Protectionism cannot help at all since its effects are once and for all, except if it accelerates the development of domestic industry. In a Keynesian world, the low constrained growth rate may even lead to continually rising unemployment (except if some sort of a NAIRU relationship exists). A further implication of these theories is that the period for which a country can maintain a CA deficit is lower than in a static model since as time goes by, ceteris paribus the BOP deficit will increase as domestic and world incomes rise.

Concluding, whether there exists an external constraint depends, as we've already said, on our view of how the economy functions. This, however, is not only so because it affects the expected consequences of a CA deficit but also because it is considers different things as being a problem. The term "external constraint" in fact refers to a number of supply-side constraints of the economy: rigid labour markets leading to unemployment or inflation when we try to reduce a deficit; inefficient financial markets causing wasteful CA deficits and low quality firms which have low income elasticities and result in slow growth. In other words there is not an external constraint as such, it is just a manifestation of (and partly a way of -temporarily- avoiding) supply-side deficiencies. This is why a floating exchange rate or one currency won't help alievate this constraint : Under a floating exchange rate it will reappear in the guise of inflation and with one currency it will result in the economic decline of the region involved.

For a classical oriented economist, not only inefficient financial markets and rigid labour markets do not exist, but he often refuses the very notion of "supply-side failure" : the economy is generally seen to perform as good as its resources allow (for example see McCloskey's denial that Victorian Britain failed). Thirlwall model is, hence, rejected since it is in fact saying how nice it would be if our income was higher. Those from a Keynesian perspective are obviously much more eager to accept that the supply-side has weaknesses which government action may be able to improve. As usual, I would position myself in the middle but I am generally weary of the tendency among many "Keynesians" to include everything under the label of 'external constraint".