Unit Six Essay

Britain had a trade deficit in its trade goods balance of £59 billion in 2005. Examine the likely causes of the deficit.

The balance of trade is the difference between a country's output and domestic demand, and does not include money re-spent on foreign stocks or imported goods that are produced for the domestic market.

Prices of manufactured goods in the domestic industry would affect the balance of payments. The decline of the manufacturing sector in Britain, in favour of the service industry, and strong global competition from emerging markets has led to a steady decline in manufactured goods being produced in Britain for the past thirty years. Examples of global competition have been evident in the decline of the car industry, and the closure of MG Rover due to intense competition from Toyota and other such immerging market car companies. As the price of manufactured goods goes up relative to other global supply, domestic firms become more uncompetitive and the country imports more as a result. Considering that the UK has a high propensity to import, the trade deficit has worsened over the years, causing an ever greater deficit than before.

However, it is not apparent as to whether the decline in manufacturing has caused the deficit or is just a harbinger of a worsening decline. Other developed economies such as Holland have been making moves towards a stronger services sector and have not experienced similar trends in their trade deficits. It also must be remembered that whereas the decline of the manufacturing industry may seem large relative to the growth of the services industry, industrial output has been fairly stable over the past five years.

Secondly, the strength of the sterling against the dollar has made our imports cheaper in comparison to the US which is our biggest trading partner in terms of countries. Since the inception of the Euro in 1999, the sterling has performed relatively well, until recent months. Considering now that the Euroland is the UK's biggest single trading partner, relatively cheaper imports and more expensive exports reduces the value of the X-M component of aggregate demand, thus reducing the increase in aggregate demand. Cheaper imports mean that the propensity to import increases and relative exports decrease, thus meaning that the deficit increases.

Nevertheless, the value of the sterling has been accompanied by a long period of benign economic growth and the strong GDP growth has also led to a greater deficit. Currently, the sterling has dropped from the record highs it reached against the dollar meaning that the reverse has begun to take place. Nonetheless due to the extreme volatility in the current financial markets, it's not certain as to which way direction the exchange rates are heading, thus meaning that the uncertain outlook will need to settle before the exchange rate can be seen as a significant contributing factor to the deficit.

Falling reserves of natural resources has meant that Britain is moving away from self-sustainability in terms on energy and thus increasingly having to import more forms of energy and fuel. The dwindling North Sea oil stocks have meant that the UK will need to import more viable fuel methods to keep up with domestic demand. This has already begun to occur and thus worsening the balance of trade deficit. This would also lead to an increase in business costs, forcing them to try and become more efficient against foreign competition. Uncompetitive businesses would also lead to a deficit as detailed above.

Britain is not the only country to be facing such a problem and therefore it depends on how hard hit the other countries are. In terms of energy, the US is also facing difficult problems in terms of finding a sustainable and economically viable source of energy to keep up with such high domestic demand. This has driven up global oil prices which have been continuously reaching record highs are currently stand at around $105 a barrel on the weak dollar.

Lastly, the balance of trade differs across the business cycle. In export led growth which is seen predominantly in the emerging markets, the balance of trade will improve during an economic expansion. However with domestic demand led growth which is seen in most developed economies such as the US, Australia and the UK, the trade balance will worsen at the same stage in the business cycle. The obvious peak in the current business cycle has been apparent since the recovery from the dotcom crash, thus implying that the balance of trade would be in deficit during strong economic growth conditions.

Nonetheless, the business cycle is not entirely left to its own devices and it is uncertain as to whether or not the government have an influence over the trade cycle and whether the definitions can be loosely changed. In such a globalised world, Britain's trade cycle has to be taken into account relative to changes and fluctuations on other major economies, especially those who are heavily linked by trade.

Evaluate measures which could be pursued by firms and by the government to improve the competitiveness British goods.

One of the main ways firms could withstand global competition and to make British goods competitive would be to make their businesses more efficient and lower their average costs such that they would be similar to the competition from the

Far East. They could do this by benefiting from economies of scale and increasing the productivity of their workers, to decrease the marginal cost of each product they produce. Greater incentives for workers, such as better overtime rates, or health benefits would achieve this.

However, with all such schemes, the cost to businesses has to be factored in. If the costs of implementing such schemes outweigh the benefit gained from productivity, the companies wouldn't bother implementing them in the first place. Considering the current economic situation the UK is facing, many firms do not have the capacity to increase productivity as their profits are being eaten up by increased business costs and inability to pass on inflationary prices to consumers due to their fears over falling demand.

Firms could also move production overseas where costs are evidently lower. Reducing business costs would allow them to spend money on other factors such as increasing productivity. Outsourcing has been a popular option for many companies due to the large pool of cheap labour in emerging and developing countries. Many of those countries also have tax incentives for foreign firms to invest and build up their infrastructure. Such has been the case of Brazil in the past decade.

The type of production process and which part of the process that could be outsourced has to be taken into consideration. Many laborious tasks are easily transferable but ones that need skills are more difficult. Outsourcing of things like call centres has begun to have a consumer backlash from the domestic consumers as they are fed up being advised by people in a different country. Such negative publicity must be considered by the company before proceeding to move overseas to cut costs. A damaged reputation is more detrimental to a business than squeezed profit margins.

Supply side policies such as education and training are long term solutions that the government could invest in to improve the competitiveness of British firms. More qualified workers would improve the performance of workers and they would be able to earn greater transfer earnings due to their skills. A more educated workforce would make the labour pool more employable globally, thus helping any firm that they work for.

Time lags from when the government implement the new policies to the time that children who have benefited from them come into the work force is considerably large therefore it is hard to measure whether or not some education supply side policies have been effective or not. Their efficiency is always questionable. Changing governments between the times when such policies were implemented also means that budgets could be cut according to different parties. The budget deficit has reached record levels again the for the first time since Gordon Brown set the sustainable investment in 1997, government debt will surpass 40% of GDP. Thus spending on education and training will be limited.

Lastly the government could provide tax incentives to attract more foreign investment. Even though Britain was the receiver of the highest levels of foreign direct investment in 2005/2006, this has dropped significantly as the UK has dropped in the global competitivity tables. Providing tax incentives would encourage firms to invest in the Britain, bringing business to the domestic scene as well as providing outlets for new research and development projects.

Nevertheless, providing a tax incentive does not necessarily mean that firms would be attracted to bring their business to Britain, given that the capital has relatively higher rent costs and generally higher wage costs than most European countries. So in conjunction with tax incentives, the government would have to provide a substantially larger incentive package to pull investors to the capital rather to other emerging market economies which have seen a massive leap investment in 2007, for example, India's benchmark Sensex index saw a 47% increase in the value of it's shares in 2007.