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‘The trade deficit on goods in the first three months of the year was £7.1bn.’

(a) Explain the meaning of this statement.

The above statements states that between January and March 1999 the UK lost £7.1 billion on trade, as a r esult of a trade deficit or current account deficit on the Balance of Payments.

A Current Account deficit is where imports into a country exceed exports. This leads to a disequilibrium of injections and withdrawals. Withdrawals from the circular flow of income exceed injections into the circular flow of income. Though the current account consists of 4 elements, visible goods, invisible services, net income and investment income, the statement above discusses the deficit of an element of the current account, the visible goods element Even though a current account deficit results in the value of imported goods exceeds the value of exported goods, the demands for exports and imports will not be affected in the short run due to the Martial Lerner Conditions. Though eventually this will result in the foreign currency price of UK exports to decline, it will take some time for countries to react to these changes. In the short run the volume of exports will remain the same before it increases as a result of devaluation in the long run. This is illustrated by the J-Curve effect below.

(b) Examine the possible causes of such a deficit.

There are a number of possible causes for a current account deficit. Because at a time when some countries will be running a current account deficit, in this case the UK for instance, other countries will be experiencing a current account surplus. Therefore it is essential to identify the underlying causes of a current account deficit before designing policies to correct the problem.

High levels of economic growth could be a reason for the deficit. In a boom, when consumption and investment expenditure tend to rise, it is inevitable that some of this increased spending will leave the country as consumers and firms purchase imports. If one assumes 'caterus paribus' this will result in the current account balance deteriorating. The greater the marginal propensity to import will be, the greater the increase in imports.

A lack of productive capacity of domestic firms could lead to this disequilibrium. If domestic producers have insufficient capacity to meet rising demand from consumers, then imports of goods and services will come into the country to satisfy this excess demand. As a result the current account will worsen.

Poor price and poor non-price competitiveness could trigger this problem as well. Competitiveness can be measured by cost levels and domestic prices relative to international competitors, but non-price factors are also important. These include quality, design, r eliability and after-sales service. Inflation is where the average price level increases, it is a key determinant of international competitiveness. If the UK has a higher inflation rate to the rest of the world it will became less competitive on the world market. Assuming the quality of goods and services and the exchange rate remain the same, the rise in inflation will reduce UK exports and increase imports, as a result creating a current account deficit.

An over valued exchange rate could also be a factor. Some economists believe that current account deficits stem from the exchange rate being to high. A high exchange rate causes export prices to rise and be higher in the

foreign markets, while imports become relatively cheaper. Assuming 'caterus paribus' this will cause imports to rise and exports to fall, the current account balance will be badly affected.

A declining comparative advantage in many areas could lead to a balance of payment imbalance. The advantage that countries have in producing certain goods and services can change over time, as technology alters and other countries exploit their economic resources and develop competing industries. The UK manufacturing sector, for example has suffered over the last 25 years from the emergence of low cost production in newly industrialised countries.

In essence a number of diverse factors can lead to a current accounts deficit, however most of the time it is a mixture of numerous issues which leads to the imbalance.

(c)Evaluate measures a government cou ld adopt to help improve the international competitiveness of a country's industries.

A government could adopt a number of measures to improve international competitiveness, the methods can be div ided into two types of policies, expenditure reducing policies and expenditure switching policies.

Expenditure reducing policies aim to reduce the spending carried out by firms and consumers alike to reduce the demand for imports and thereby causing imports to decline. This policy could be implemented through th e imposition of higher income tax of higher interest rates. Higher income tax will reduce real disposable incomes and should lead to a fall in expenditure on imports. The imposition of higher interest rates by the Bank of England will discourage borrowing, encourage savings and reduce consumers real 'effective' disposable incomes. This method too will lead to a fall in consumer spending and a reduction in the level of imports. However, expenditure reduction policies carry a few problems. These policies only provide a short term solution to a current account deficit problem, they do not tackle its

underlying problems. They also reduce aggregate demand and this will result in lower economic growth and higher unemployment.

Expenditure switching policies are another method of dealing with a current account deficit problem. These policies attempt to encourage consumers to switch their demand away from imports and towards the output of the domestic firms. This will only occur however if the relative price of imports can be raised, or if the relative price of UK products can be lowered. This should then cause a change in the spending patterns of consumers, away from foreign goods towards output produced within the domestic economy. This could be carried out in a number of ways. Tariffs or other import controls could be imposed. Policies to reduce the rate of inflation in the economy below that of other international competitors could be implemented. Output of domestic firms could be made relatively cheaper through the reduction of unit costs to encourage higher investment and labour productivity. A depreciation of the exchange rate could also be beneficial, it would reduce the price of exports and increase the price of imports making the former more competitive. This should then stimulate foreign demand for exports and encourage UK consumers to purchase fewer imports and more domestic products. Assuming caterus paribus this will result in an improvement of the current account balance. However, according to the Marshall Lerner Condition, a depreciation of the exchange rate may not improve the current account deficit in the short term. This is due to the price elasticity of demand for imports and exports in the immediate aftermath of an exchange rate change, changes take a certain amount of time to occur. This problem is illustrated through the J curve.

Assume an economy starts at position A with a substantial current account deficit as a result of depreciation in the value of the exchange rate, initially the volume will remain steady because contracts for imported goods and services will have already been signed, and the demand for exports will not change significantly because export contracts will have already been signed. As a result the current account deficit may worsen in the short run. However, if we assume that the demand for exports and imports is elastic, the current account balance will improve in the long run. This is the Marshall Lerner Condition, in which firms will begin to start signing new contracts that will take into account the relative price changes. If the elasticities of demand for imports and exports are much higher than the deficit, a current account surplus can occur.

It is important to understand that the depreciation of the exchange rate alone will not be sufficient to correct a current account deficit, other policies will also be needed to improve supply side performance and make domestic goods and services more competitive in the international market.

The key to controlling a current account deficit in the long run if for the economy to achieve a relatively low inflation with sufficient productive capacity to meet the demand of the consumers. This will require a period of low interest rates, low inflation and competitive exchange rates matched with non-price competitiveness abroad.