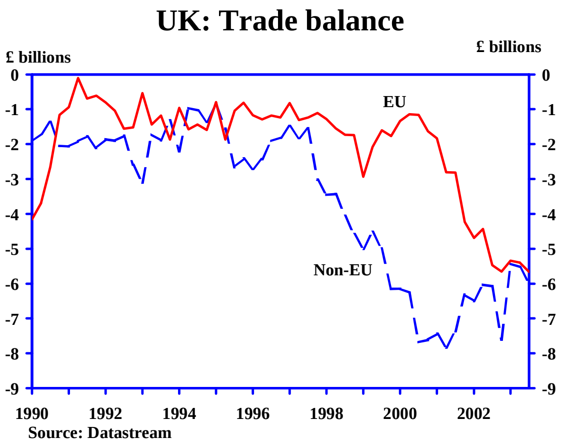
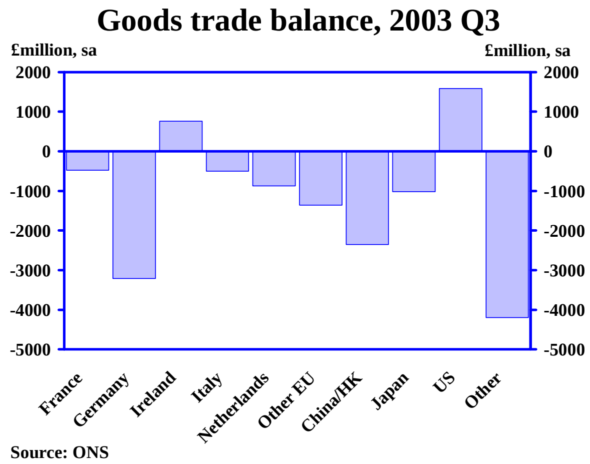
Why is the UK trade position with the EU so weak?

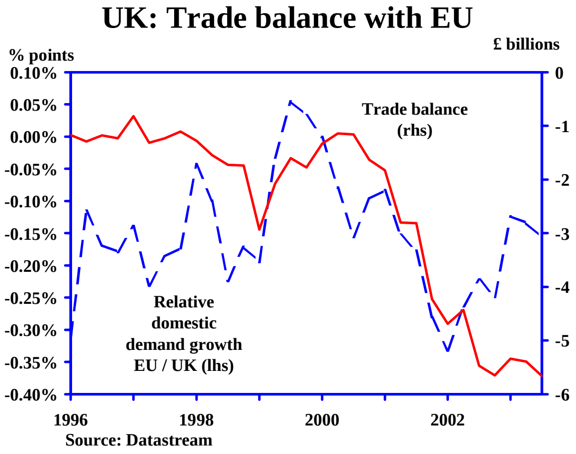
The UK current account deficit reached an all-time high in the third quarter. To some extent, that can be explained by stronger growth in demand in the UK than in many of its trading partners – particularly in Europe. But it seems that the deterioration in the UK's trade position vis-à-vis Europe has been more pronounced that the growth differential would normally explain. Since that deterioration has accompanied a marked depreciation in the value of sterling against the euro, it is even more puzzling. The solution may involve three factors: so-called J-curve effects; the composition of UK exports to the EU; and a loss in non-price competitiveness of UK exporters to Europe. To the extent that the first two are to blame, the problem may only be temporary. If it is the third, then that might imply that sterling is still overvalued against the euro.

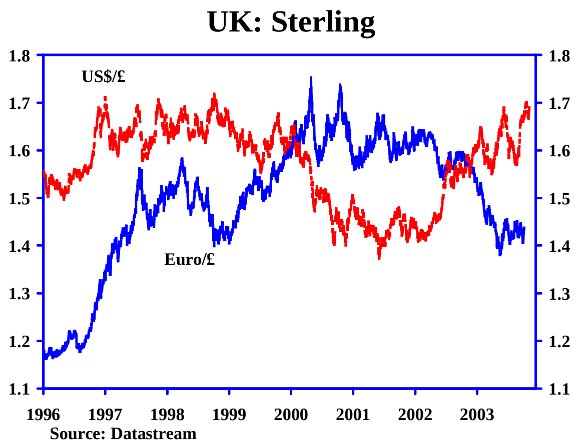




The deterioration in the UK trade balance against the non-EU coincided with the Asian and emerging markets crisis of 1998/99, and it has remained substantial ever since. But the deterioration against the EU is a phenomenon of the last two years, and it continues to get worse. Within the EU, the largest deficit is with Germany, worth over £3 billion in Q3. The UK is still running a surplus against Ireland, and only small deficits with France and Italy. The relatively large deficit with the Netherlands is deceptive, as much of the trade to and from the Netherlands is actually sourced and destined elsewhere.

What accounts for the recent deterioration against the EU? The first candidate is relative domestic demand: the rest of Europe has undergone a much more pronounced cycle in demand in recent years than has the UK – largely because of the contrast between aggressive loosening of both monetary and fiscal policy in the UK and relatively cautious policy responses in the Eurozone. The relative strength of domestic demand is undoubtedly one factor explaining the weak performance of UK trade with the EU – probably the most important single factor – but it does not tell the whole story.



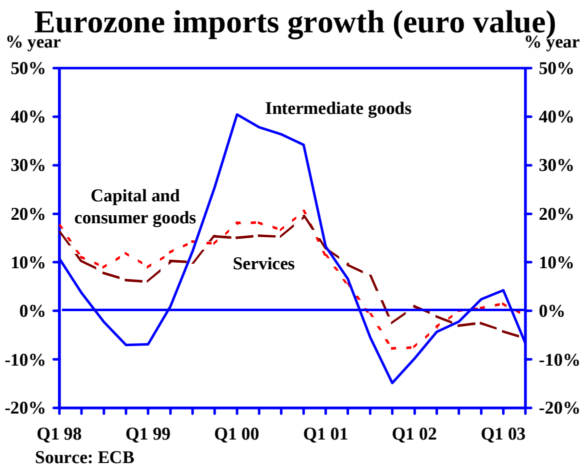


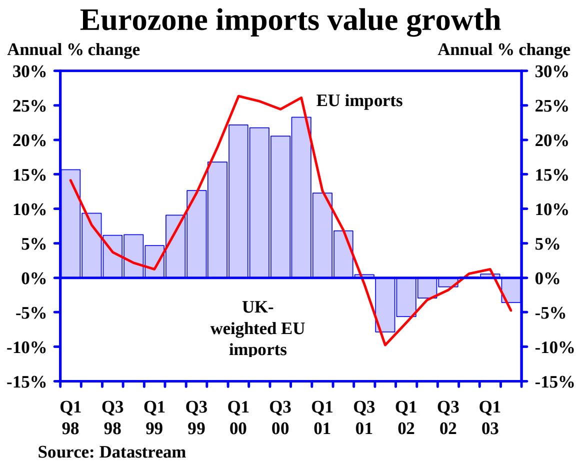
The chart above (on the left) shows the UK trade balance with the EU, and compares it with the domestic demand growth rate differential between the two regions. Certainly it is the case that the first phase of deterioration in the UK trade balance with the EU was associated with a slowdown in EU domestic demand compared to the UK. But, since the start of 2002, the growth differential has actually narrowed significantly, while the trade gap has continued to increase. Moreover, this has occurred over a period when, as the chart on the right shows, UK exports have become more competitive in Europe as a result of the depreciation of sterling against the euro. If anything, we should have expected the trade balance with the EU to improve by more than the extent to which the growth differential has narrowed, as UK exports benefited from improved competitiveness. Instead, the reverse has happened.

Part of the explanation might be so-called ‘J-curve’ effects. These occur when a change in the value of a currency – such as a depreciation of sterling – has a ‘perverse’ effect on the current account balance in the short term. Suppose a UK importer from the EU is bound into import contracts at prices denominated in euros. If sterling depreciates, those same imports will be worth more in pounds. Only when new contracts are drawn up will prices and volumes adjust to the new exchange rate. Of course, some UK exporters will also be tied into contracts denominated in euros. But if the UK starts from a position of deficit vis-à-vis Europe, or if more import price contracts than export price contracts are denominated in euros, then a depreciation of sterling could have the short-run net impact of a deterioration in the sterling current account position.

J-curve effects may be present in the UK trade account with the EU. But, in theory at least, we would expect those effects to be contemporaneous with the depreciation of the currency. The biggest puzzle is really since the middle of last year, over which period most of the currency depreciation had already occurred. That leaves something left to explain.

One other candidate explanation is the composition of EU demand for imports. UK exports are to an unusual extent service sector exports, and EU service sector imports (from all sources) have fallen relatively rapidly in recent quarters. However, in spite of that, it seems that in the round, composition effects cannot be to blame for the weakness of the UK current account position with Europe. If we construct a UK export-weighted measure of EU imports, to try and get hold of what has happened to the UK’s market share (assigning a suitably high weight to service sector imports, for example), it turns out that EU imports measured on this basis have actually been slightly ***stronger*** than otherwise. If anything, composition effects should have ***improved*** the UK’s current account position, not caused it to deteriorate.





Of course, it would be dangerous to draw firm conclusions from the experience over such a short space of time, particularly when the issue is trade flows, where the data are relatively poor, and can be revised substantially over a number of years. But, to the extent that the weakness in UK trade with the EU over the last year or so is genuine, and the domestic demand and other figures are accurate, it suggests that there might have been a loss of non-price competitiveness on the part of UK exports over that period. If so, and if that loss is permanent, it might suggest that sterling is still somewhat overvalued against the euro. But it is still too early to be confident of that conclusion.

THE LATEST DATA IN DETAIL

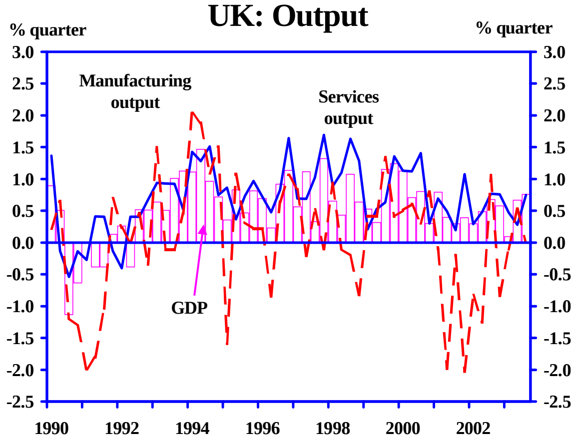
Provisional GDP (Q3)

GDP:	+0.7% q/q, +2.0% y/y
Manufacturing output:	+0.0% q/q, -0.4% y/y
Services output:	+0.8% q/q, +2.3% y/y
Household consumption:	+0.7% q/q, +2.5% y/y
Government consumption:	+0.6% q/q, +4.3% y/y
Investment:	-1.3% q/q, -0.0% y/y
Exports:	+0.1% q/q, -4.3% y/y
Imports:	+1.0% q/q, -0.9% y/y

Q3 GDP growth was revised up slightly from previous estimates. Manufacturing output stagnated as higher output in the textiles, leather and clothing industries was offset by declines in transport equipment, coke, refined petroleum and nuclear fuels. Overall industrial production declined by 0.2% with a fall in North Sea oil production only partially offset by higher output in the gas and water supply industries. The services sector grew strongly – a reflection of the pick-up in the business and financial services sectors.

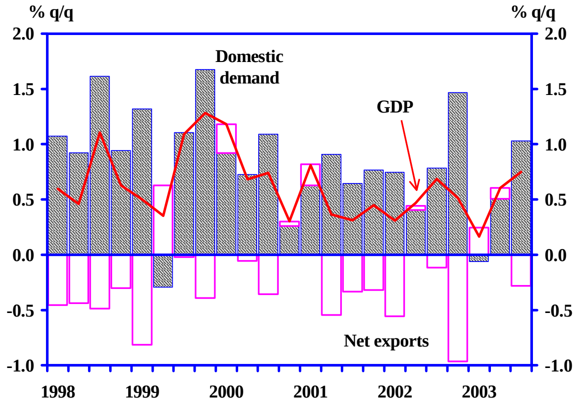
On the demand side, the pace of consumer spending was unchanged from that in Q2 while government consumption picked up slightly. But business investment spending fell as higher construction related activity was more than offset by lower spending on plant and machinery. The deteriorating trade performance mirrors robust domestic demand: net trade knocked 0.3% points off growth in Q3 after a modest positive contribution in the previous quarter.

UK: Output



Source: Datastream

UK: Contributions to GDP growth



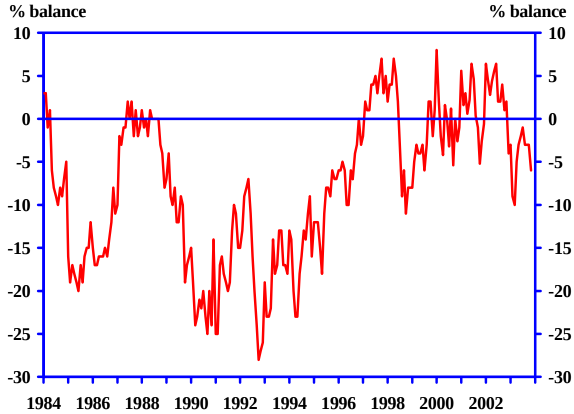
Source: OEF

Consumer Confidence (Nov)

Bal:	-6 (down 3)

November's increase in interest rates was probably the trigger behind the decline in consumer confidence. But having said that it's too early to draw any firm conclusions about consumer spending given that the index is still above its' historical average and other consumer demand indicators are robust. In addition consumers were just as optimistic about their personal finances in the year ahead as they were in October. While we expect overall consumer demand to remain healthy towards the end of the year, the dip in confidence suggests spending on consumer durables could suffer – there was a sharp drop in the sub-index measuring major purchase intentions.

UK: Consumer confidence



Source: EC / GfK

UK WEEKLY BRIEF

House price inflation (Nov)

Nationwide: +1.2% m/m; +15.2% y/y

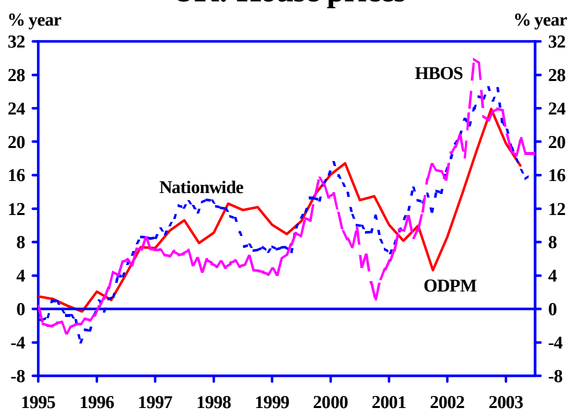
House price inflation eased during the month after posting strong growth in October. But the slowdown probably had little to do with November's 25bps increase in interest rates. We expect house price inflation to continue to ease in annual terms as we move into 2004, and a soft landing for the housing market remains the most likely scenario given we don't expect a sharp deterioration in the labour market.

CBI Industrial Trends (Nov)

Orders books: -24
Export orders: -27
Output expectations: -2
Price expectations: -15

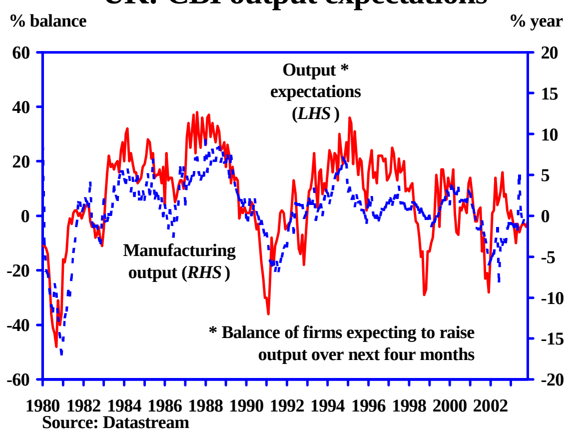
The pace of decline in total orders slowed after October's sharp drop. That was largely a reflection of strength in the domestic economy although export orders also fell by less than they did last month. At least the survey offers hope that the worst is over in the sector. Even so, manufacturers expect output to remain broadly unchanged over the next three months and export orders remain significantly below normal levels so the recovery is likely to be a drawn out process.

UK: House prices



Source: Datastream

UK: CBI output expectations



Source: Datastream

THE WEEK AHEAD

	Previous data	Forecast	Comment
1st – PMI - manufacturing (Nov)	+54.2	-	The PMI indicates the sector is growing but this has not been reflected in the official production data.
1st – Lending to individuals (Oct)	Total lending: +1.1% m/m +14.0% y/y	Total lending: +1.0% m/m +13.8% y/y	According to the BBA figures there's no sign of a slowdown in consumer borrowing despite higher interest rates.
1st – Narrow money – provisional (Nov)	+0.5% m/m +7.3% y/y	+0.5% m/m +7.7% y/y	Weekly money supply figures point to growth at a similar pace to that in recent months.
3rd – PMI services (Nov)	+59.1	-	The PMI survey indicates robust growth in the services sector.
3rd – CBI distributive trades survey (Nov)	Volume of sales reported: +35	-	Retailer's own expectations suggest another good month for sales despite the dent in consumer confidence.
4th – MPC interest rate decision (Dec)	3.75% (up 25bps) 8 - 1	Hold	There's little inflationary pressure around so there's no need for the MPC to raise interest rates quickly.
HBOS house prices (Nov)	+1.5% m/m +18.6% y/y	-	According to the Nationwide index house price inflation eased in November.

Key Indicators: United Kingdom

Percentage changes on a year earlier unless otherwise stated

	Manuf. output	Retail sales	Unempl-oyment *claimant%*	CBI total orders *% bal.*	Headline RPI	RPI ex-MIPs	Average earnings *headline*	Trade balance *£bn*
2002								
Dec	-0.9	7.2	3.1	-32	2.9	2.7	3.8	-3.8
2003								
Jan	-0.9	4.4	3.1	-25	2.9	2.7	3.6	-3.9
Feb	-1.0	2.6	3.1	-31	3.2	3.0	3.2	-3.2
Mar	-1.4	3.2	3.1	-30	3.1	3.0	3.5	-3.7
Apr	-1.0	1.8	3.1	-29	3.1	3.0	3.3	-2.4
May	-1.7	2.8	3.1	-29	3.0	2.9	3.4	-4.0
Jun	4.8	4.6	3.1	-27	2.9	2.8	3.0	-4.5
Jul	0.2	3.3	3.1	-37	3.1	2.9	3.3	-3.4
Aug	-0.8	3.3	3.1	-24	2.9	2.9	3.4	-3.4
Sep	-0.4	4.0	3.1	-33	2.8	2.8	3.6	-4.8
Oct	-	3.7	3.0	-40	2.6	2.7	-	-
Nov	-	-	-	-24	-	-	-	-

Source: ONS, Datastream

Financial Indicators: United Kingdom

Percentage changes on a year earlier unless otherwise stated

	Short rate *%*	Long rate *%*	Money Supply *M4 % year*	Exchange rate *€/£ avg.*	Exchange rate *$/£ avg.*	Exchange rate index *1990=100*	Share price *FTSE All-share*	Reserves (net) *£bn*
2002								
Dec	4.0	4.7	7.1	1.56	1.59	105.5	1901	15.6
2003								
Jan	4.0	4.4	6.5	1.52	1.62	104.0	1827	16.0
Feb	3.9	4.3	6.6	1.49	1.60	102.2	1755	15.9
Mar	3.6	4.1	7.1	1.46	1.58	100.6	1748	15.8
Apr	3.6	4.3	8.0	1.45	1.57	99.8	1853	16.0
May	3.5	4.3	8.3	1.40	1.62	97.9	1933	16.6
Jun	3.4	4.1	8.1	1.42	1.66	99.6	2009	16.4
Jul	3.6	4.1	8.0	1.43	1.63	99.5	2003	16.2
Aug	3.4	4.5	7.2	1.43	1.59	99.1	2064	16.4
Sep	3.6	4.6	7.4	1.43	1.61	99.3	2099	17.0
Oct	3.7	4.5	7.4p	1.43	1.68	99.7	2121	17.0
Nov	-	-	-	-	-	-	-	-

Source: ONS, Datastream