03.07.15

Copies to Demand and Supply Issues Team

From

JULY PRE-MPC FOLLOW UP: IMPACT OF THE EXCHANGE RATE ON THE CURRENT ACCOUNT

Kristin Forbes asked about the extent of the role played by the exchange rate on the current account balance, in particular on the primary income balance.

Chart 1: Current account balance

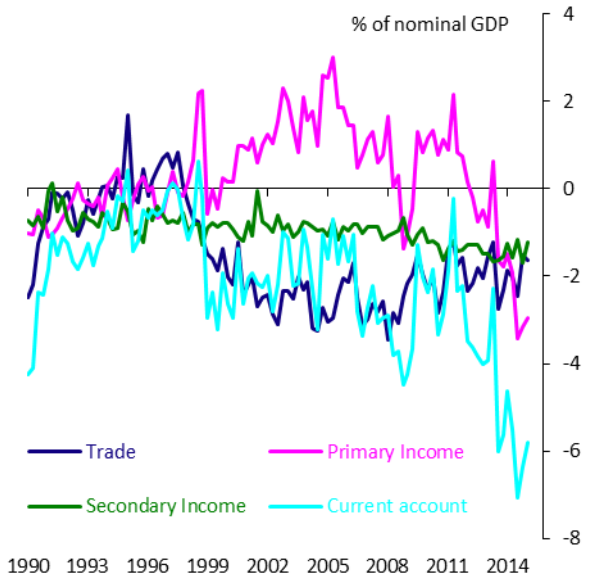


Chart 1 shows the drivers of the current account. Whilst trade and secondary income have consistently pulled down on the current account lower primary income in the second half of last year pushed the overall deficit above 7% of GDP in Q3. There has since been some improvement, leaving the current account at -5.8% of nominal GDP in Q1.

The charts below provide a qualitative illustration of the link between the credit components of investment income and year on year movements in the Sterling effective exchange rate. The grey bars indicate periods in which there were year-on-year falls in the effective exchange rate.

Charts 2 to 5 show that periods of exchange rate depreciation are often associated with some improvement in income flows, across all four investment income categories. Simple correlations confirm there being at least some inverse relationship between the income components on investment income and movements in the effective exchange rate (Table 1). The correlations are in general relatively small, but are strongest for FDI and other investment income. The evidence is less clear when bilateral exchanges rates for the dollar and Euro are used.

Table 1: Correlation between the exchange rate and income components of investment income

		Income - Credit (levels)			
		FDI	Debt	Equity	Other investment
Y-o-Y % change	£ERI	-0.26	-0.23	-0.07	-0.24

Chart 2: FDI income and Sterling effective exchange rate

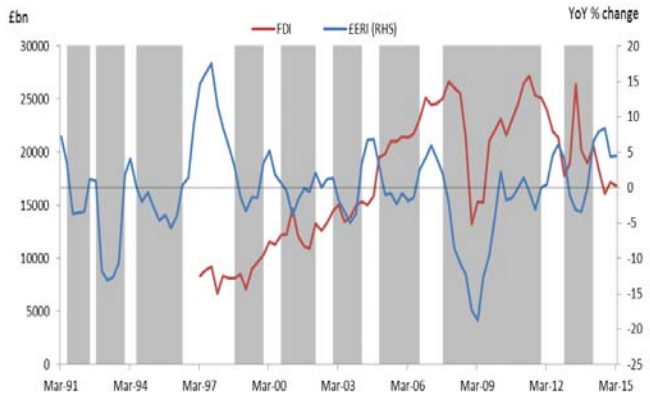


Chart 3: Debt income and Sterling effective exchange rate

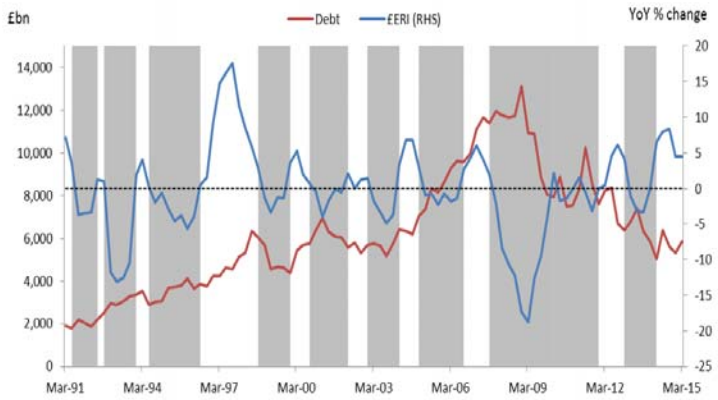


Chart 4: Equity income and Sterling effective exchange rate

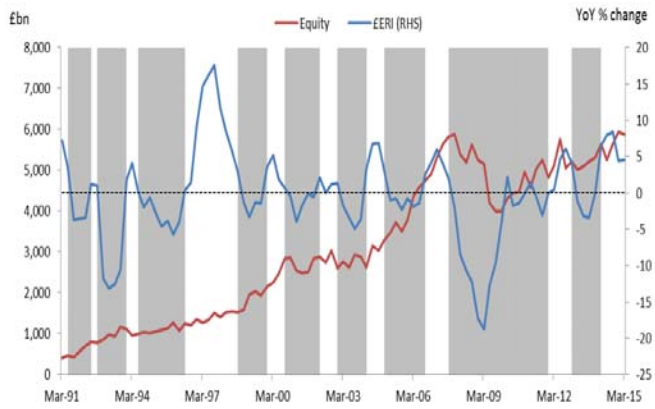
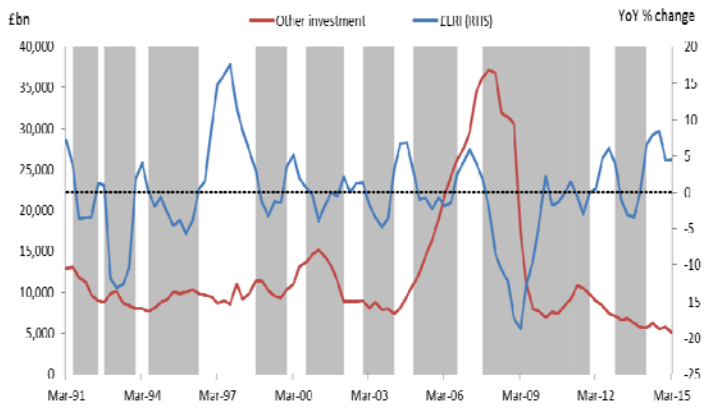


Chart 5: Other investment income and Sterling effective exchange rate



Quantitative evidence on the extent to which exchange rate changes affect the current account can be found in a recent note by and The note estimates the impact of a depreciation of Sterling on the net international investment position (NIIP), suggesting that a 10% depreciation would improve the NIIP, as a % of nominal GDP, by roughly 18pp. Using this estimate we can then back out the impact on the income flows. Assuming the rate of return per annum is 2%, a depreciation in Sterling of 10% amounts to roughly a 0.36pp improvement on the current account deficit, via income channels alone.

Whilst the exchange rate is likely to play an important role in the current account, in particular through the trade account, it is less clear that the exchange rate has been a large driver in the deterioration in the income component of the current account.