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The UK Current Account Deficit: Risky or Risk-Sharing?

In a speech to the Official Monetary and Financial Institutions Forum (OMFIF) in London, external MPC member Kristin Forbes explores the risks from the UK's current account deficit. She concludes that current account deficits can be not only "risky" but in some cases "risk-sharing" and that the latter applies to some extent to the UK's current account deficit today.

Sixty years ago, the Suez crisis "highlighted the power of foreign investors to deal a 'blow' to economies that are reliant on foreign financing." With the UK's current account deficit currently standing at 5.1% and both global and domestic risks to the UK increasing, Kristin says it is right to ask whether the UK is again overly vulnerable due to its reliance on foreign financing. But, Kristin argues, there are "compelling reasons why today's current account deficit may not be alarming – and why today's situation is fundamentally different than in 1956."

Firstly, Kristin reconsiders the evidence on the link between large current account deficits and country vulnerability—focusing on recent evidence highlighting the growing importance of financial channels as opposed to trade. Secondly, she shows that the increase in cross-border financial exposures since the early 1990's has made these financial channels more important. Kristin offers an in-depth analysis of the impact of these changes and concludes that "any analysis of vulnerabilities related to current account deficits should no longer just treat the current account deficit as a trade deficit". For example, "heightened risk and uncertainty can not only lead to challenges financing a current account deficit, but also affect the exchange rate, the relative returns that foreign and domestic investors earn, and the valuation of any international borrowing and investments."

Applying this framework to the UK today, Kristin assesses how various risks could affect these vulnerabilities related to the current account. She finds that in the case of increased domestic uncertainty, such as could occur in the run-up to June's vote of the UK's membership of the EU, "the UK's international portfolio has a number of characteristics that would be expected to generate some risk-sharing". This is due to the structure of UK international assets and liabilities, combined with the impact of a sterling depreciation which usually accompanies an increase in risk. A depreciation would increase the value of UK assets relative to its liabilities—thereby improving the UK international investment position.

Some of these effects also occur after heightened global risk, such as recently occurred from concerns about emerging markets, although “the case is less clear-cut than after heightened domestic risk”. Historically heightened global risk has aggravated—rather than mitigated—the risks from UK international vulnerabilities, but this may be changing as more of UK liabilities have recently shifted towards equity and FDI.

Kristin concludes from the above that whilst the magnitude of the UK’s current account deficit does increase our “vulnerability to a sudden stop in capital flows”, the make-up of the UK’s current account means it can also play a role in risk-sharing. “This should not be taken to suggest that heightened domestic risk does not present any concerns for the broader UK economy.” This risk sharing partially occurs through a fall in sterling, which would have additional effects. “Perhaps most important, the estimated magnitude of this potential risk sharing through international exposures is moderate and would be unlikely to fully counteract the many negative effects from increased uncertainty on the broader UK economy.” Also, by focusing on fast-moving financial channels, the analysis does not evaluate the longer-term impact if risk was elevated for a prolonged period—which would generate additional adjustments.

However, the analysis does suggest that analysis of the vulnerabilities related to current account deficits must extend beyond headline statistics to the role of financial adjustments to determine the extent to which current account deficits may be “risky” or “risk sharing” in any given country and scenario.

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