Office for National Statistics

Article

International economic statistics: UK's current account explained

A brief summary of key concepts, components and trends in the UK’s current account, and how it relates to the national accounts.

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1 . What is the current account and what is it made of?

The current account provides a summary of a nation’s transactions with the rest of the world. The net position of these flows is called the current account balance, and it comprises:

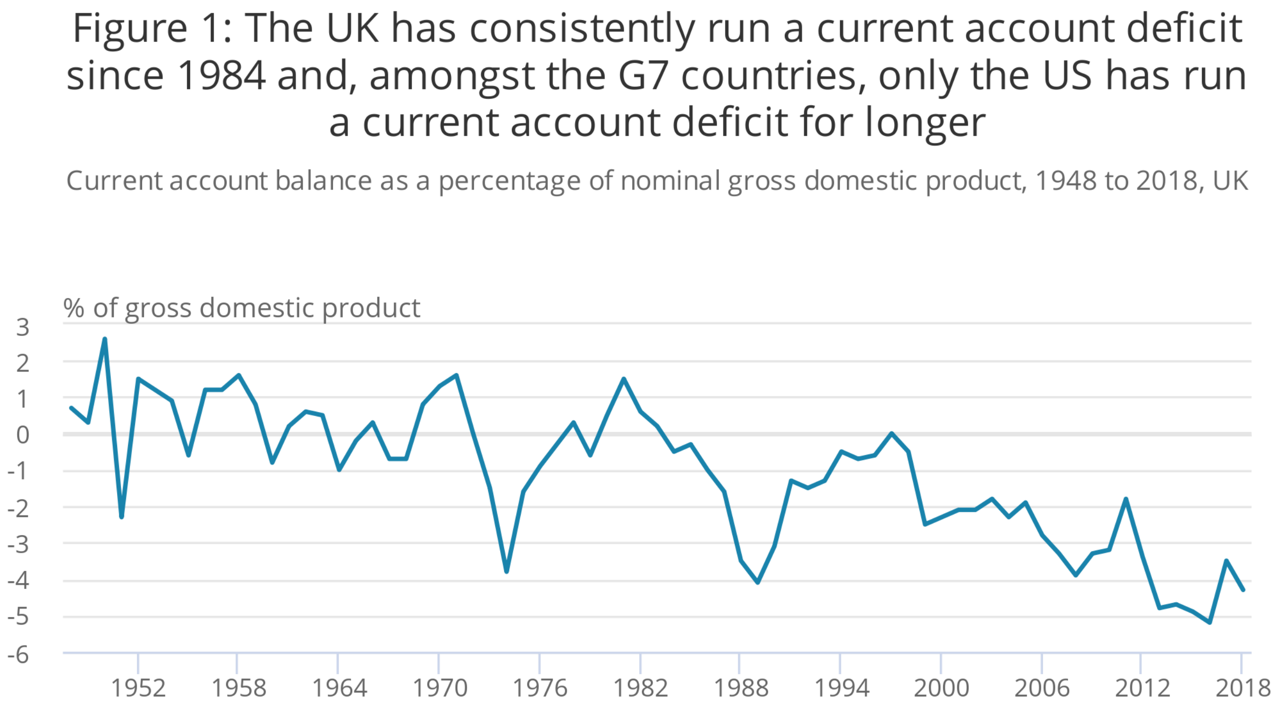
- net trade
- net primary income
- net secondary income

A positive current account balance (a surplus) means that the country received greater inflows from abroad than it had outflowing to, for example, foreign consumers, investors, governments, and workers. In national accounts terms, a surplus reflects a net lending position, meaning that the country is more than able to fund its economic activity in the world economy.

On the contrary, a negative current account balance (a deficit) means that the country had fewer incomings from abroad than it had outgoing to foreign consumers, investors, governments, and workers. A deficit reflects a net borrowing position, meaning that the country is reliant on money from abroad to fund its economic activity in the world economy.

Figure 1: The UK has consistently run a current account deficit since 1984 and, amongst the G7 countries, only the US has run a current account deficit for longer

Current account balance as a percentage of nominal gross domestic product, 1948 to 2018, UK



Source: Office for National Statistics - Balance of payments

Notes:

1. Series YBHA used for nominal gross domestic product.

Trade

Trade is the buying and selling of goods and services, with compensation provided to the seller.

The selling of goods and services to a foreign country are exports, and they generate income for the selling country (also referred to as “credit” or “inflows”). The buying of goods and services from a foreign country are imports and result in an outflow of money (also referred to as “debits”).

The balance between the exports and imports of goods and services is known as the “balance of trade”’. If positive, it is known as a trade surplus. If negative, it is known as a trade deficit.

Figure 2: The UK has run a trade deficit in every year since 1998 and, in 2018, it experienced its highest deficit as a percentage of GDP since 2010

Total trade balance as a percentage of nominal gross domestic product, 1948 to 2018, UK

Source: Office for National Statistics - Balance of payments

Notes:

1. Series YBHA used for nominal gross domestic product.

Trade involves goods and services.

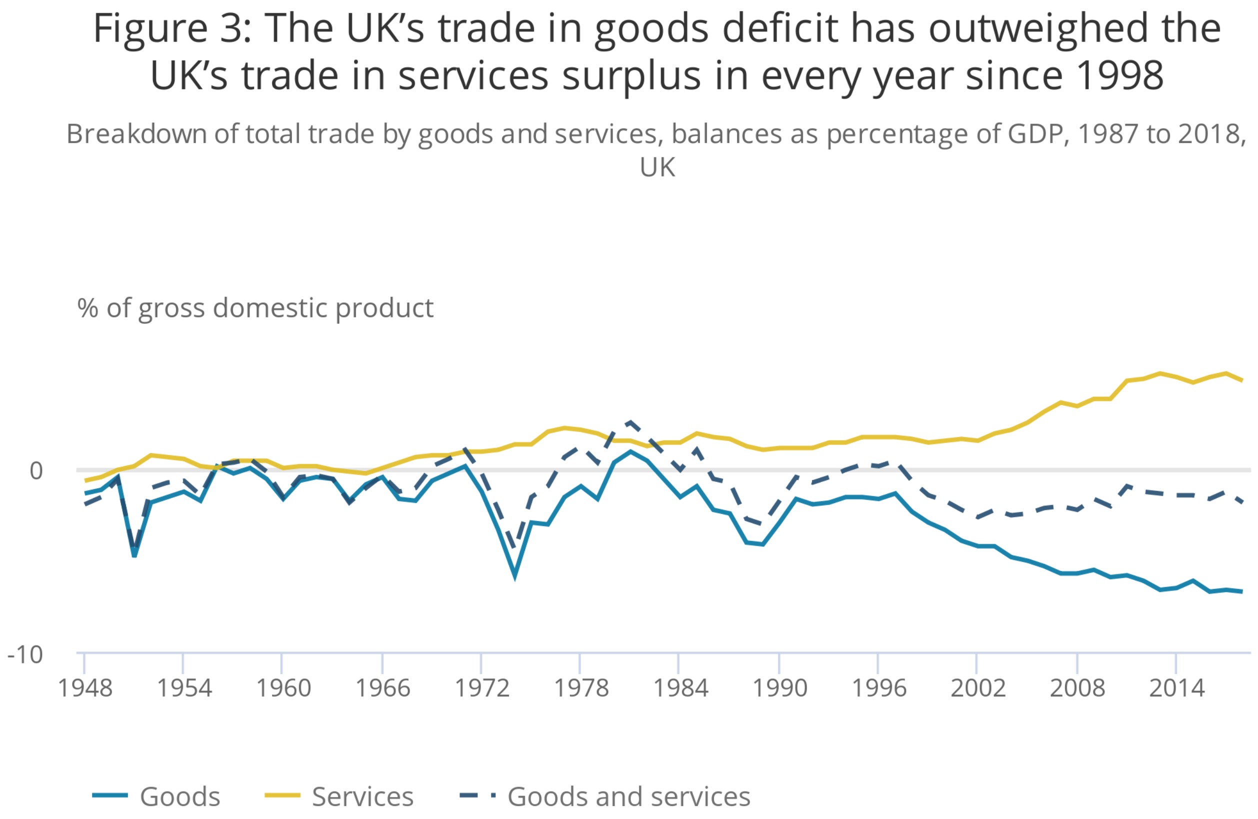
Goods are “physical, produced items over which ownership rights can be passed from one institutional unit to another, by engaging in transactions”. Services are “the result of a production activity that changes the conditions of the consuming units or facilitates the exchange of products or financial assets” (Balance of Payments Manual 6, 2014 (PDF, 3MB)). For example, when purchasing a new smartphone, the smartphone is the good, but internet data allowance is a service and so is any potential insurance and financial loan that further facilitates the exchange of this product.

UK trade consists mainly of goods (for example, cars, oil and medicinal and pharmaceutical products), more so than services (for example, financial, travel and transport services). Nevertheless, the importance of both trade in goods and services to the UK economy has grown over time as their value relative to the UK economy has generally increased. Furthermore, their balance is also important.

The UK is reported to have held a trade in goods deficit in every year since 1983, and a trade in services surplus in every year since 1966, as Figure 3 highlights.

Figure 3: The UK's trade in goods deficit has outweighed the UK's trade in services surplus in every year since 1998

Breakdown of total trade by goods and services, balances as percentage of GDP, 1987 to 2018, UK



Source: Office for National Statistics - Balance of payments

Notes:

1. Series YBHA used for nominal gross domestic product.

In summary, trade figures capture the monetary flows generated in the cross-border selling and buying of goods and services.

Primary income

Primary income mainly reflects the monetary flows generated from the owning of cross-border financial assets, known as investment income. It represents the yields (that is, returns) from UK investments abroad and that of foreign-owned investment in the UK. Primary income also includes remunerations for cross-border workers (known as compensation of employees); these include seasonal or short-term workers (for less than a year), embassy workers and workers of international organisations.

Income generated from the owning of financial assets (that is, investment income) is by far the largest component of the UK's primary income. There are different forms of investment income and these are broken down into what are called functional categories (see Table 1).

Table 1: Breakdown of investment income in the current account, by functional category

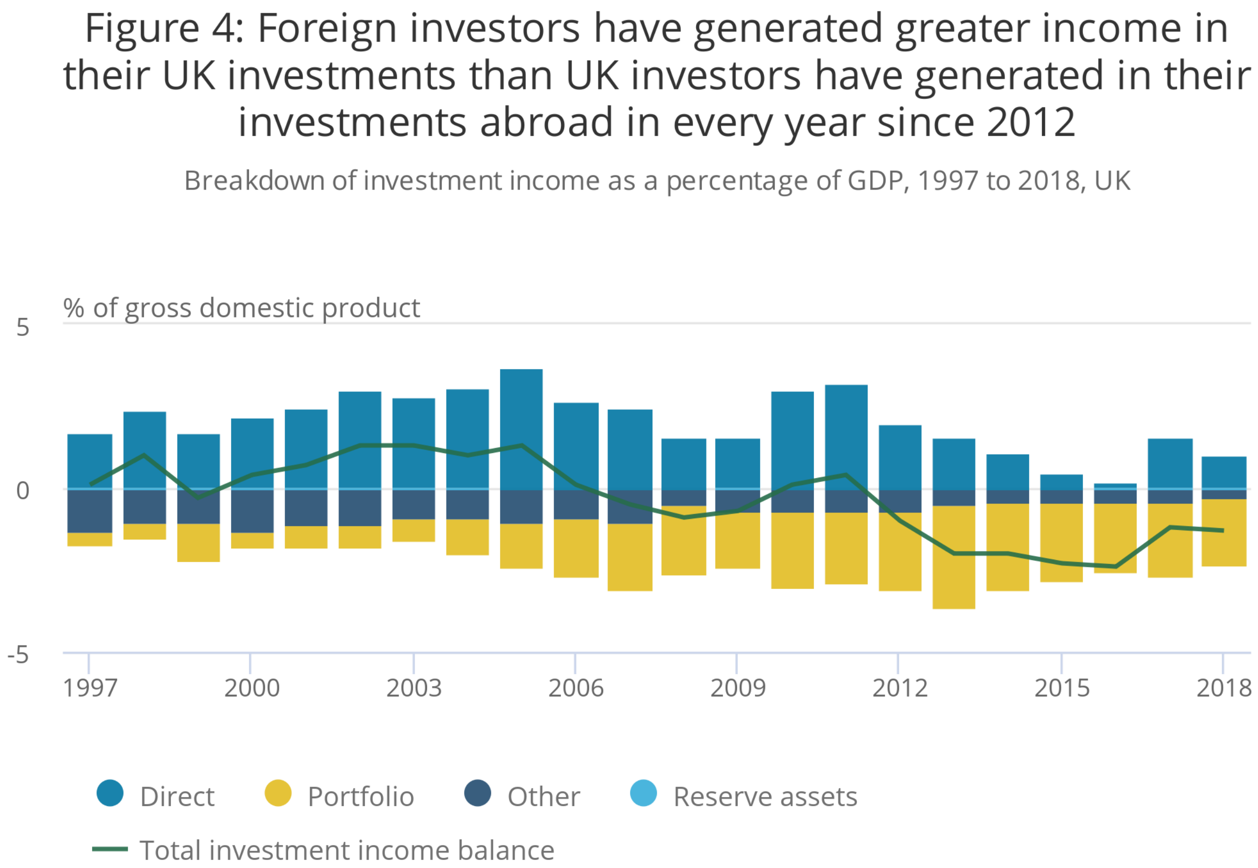
Investment income		
Foreign Direct Investment	**Portfolio investment**	**Other investment**
Income generated via investments whereby the investor holds 10% or more of the equity share (and therefore a significant controlling influence over the company).	Income generated via investments whereby the investor holds less than a 10% of the equity share (and therefore does not have a controlling influence over the company). Portfolio investment also includes investments in debt securities (such as corporate or government bonds).	Income generated from being an issuer of a loan and/or an owner of currency and deposits. Reserve assets (for example, foreign exchange reserves) also generate income and are regarded as a separate functional category.

Source: Office for national Statistics

The largest component of the primary income deficit in 2018 was a portfolio investment deficit, as Figure 4 shows, partly offset by a direct investment surplus. Other investment income (including reserve assets) takes up smaller amounts of the investment income balance.

Figure 4: Foreign investors have generated greater income in their UK investments than UK investors have generated in their investments abroad in every year since 2012

Breakdown of investment income as a percentage of GDP, 1997 to 2018, UK



Source: Office for National Statistics - Balance of payments

Notes:

1. Series YBHA used for nominal gross domestic product.

Secondary income

Secondary income in the context of the balance of payments is “current transfers between residents and non-residents” which captures the provision of an economic value by one party, without directly receiving a counterpart item of economic value. In other words, these are transactions that represent “something for nothing” (Balance of Payments Manual 6, 2014 (PDF, 3MB)). This can be in the form of money or of goods or services, without the expectation of payment. Examples include foreign aid, and contributions to international organisations.

As Figure 5 shows, the UK currently has a secondary income deficit and it has done so since 1960, mainly because of general government transferring more money abroad than it receives.

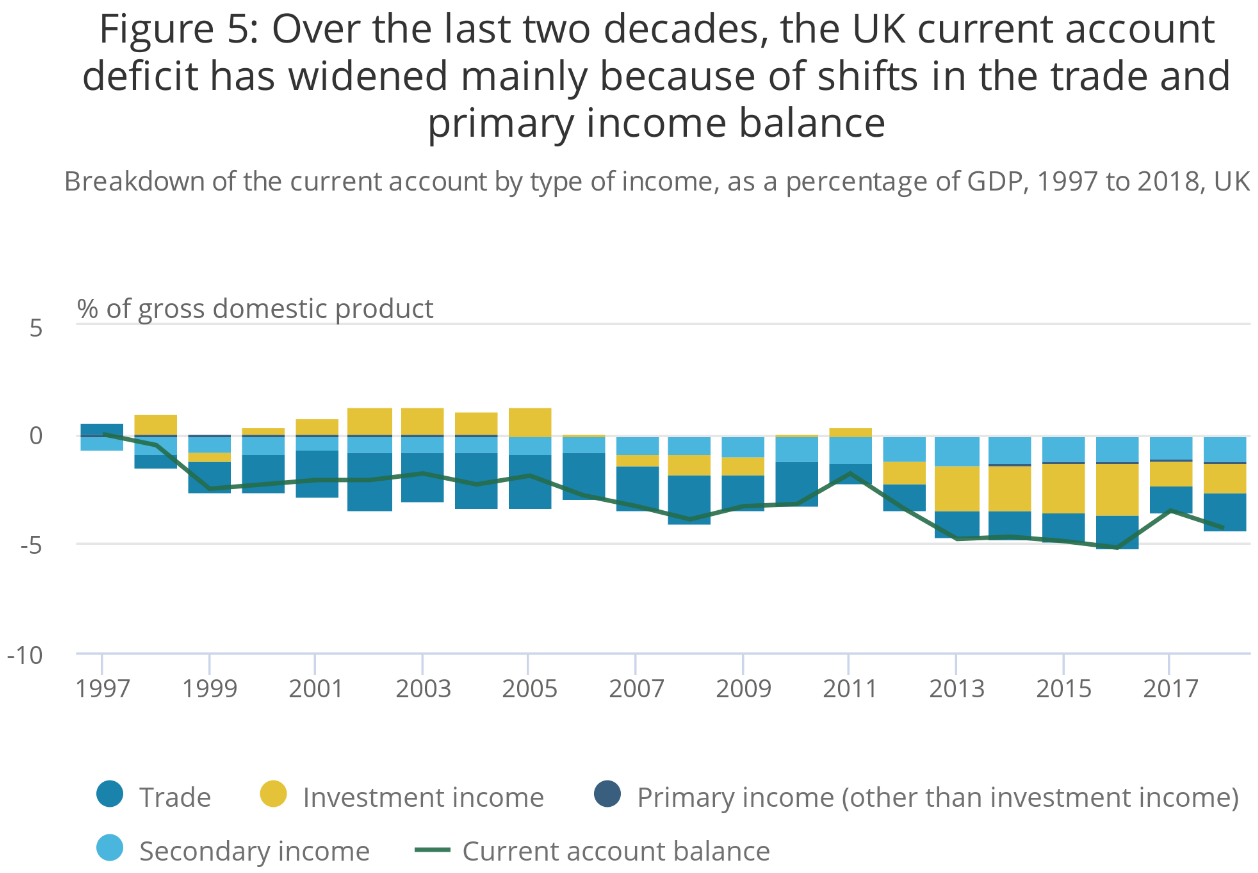
This concludes an introduction to the main components that make up the current account. But how has the UK current account changed over the past two decades?

2 . Recent history of the UK current account

Over the last two decades or so, the UK current account deficit has widened from 0% of GDP in 1997, to over 4% in 2018. As Figure 5 shows, this trend is mainly the result of shifts in the primary income balance (from surplus to deficit).

Figure 5: Over the last two decades, the UK current account deficit has widened mainly because of shifts in the trade and primary income balance

Breakdown of the current account by type of income, as a percentage of GDP, 1997 to 2018, UK



Source: Office for National Statistics - Balance of payments

Notes:

1. Series YBHA used for nominal gross domestic product.

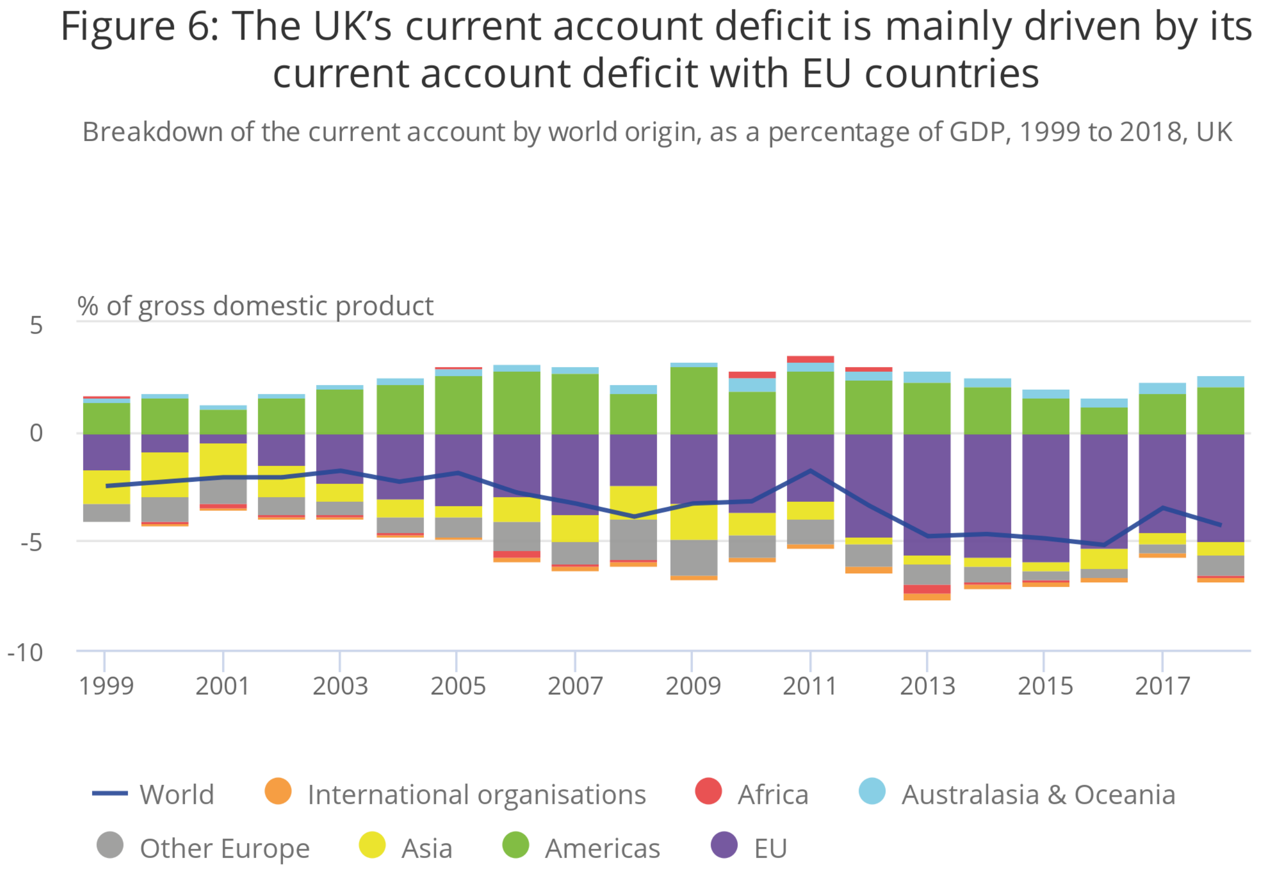
Primary income generally contributed positively to the current account, with an average surplus of 0.8% of gross domestic product (GDP) between 1998 and 2006. This implies that UK investments abroad experienced better returns than foreign-owned investments in the UK. These better returns can arise from better yields and/or greater levels of investments. However, since 2007, primary income has often been in deficit, highlighting that returns from foreign-owned investments in the UK are now greater than that of UK-owned investments abroad. Driving this shift is mainly income paid to foreign-owned UK debt securities, such as bonds, highlighting the relative “safe haven” perception of UK Government debt.

A widening trade deficit at the turn of the century also played a part in the widening current account deficit. In the decade leading up to the period of the economic downturn (2008), the trade deficit averaged 2.1% of GDP before narrowing to an average of 1.4% in the decade following the economic downturn (2009 to 2018).

The origin of the trade deficit has also shifted over the last two decades. In the decade leading up to the economic downturn, almost 60% of the trade in goods deficit (the main driver of the total trade deficit) came from trade with non-EU countries. Since the economic downturn, the composition has reversed, and now 60% of the trade in goods deficit comes from trade with the EU.

Figure 6: The UK’s current account deficit is mainly driven by its current account deficit with EU countries

Breakdown of the current account by world origin, as a percentage of GDP, 1999 to 2018, UK



Source: Office for National Statistics - Balance of payments

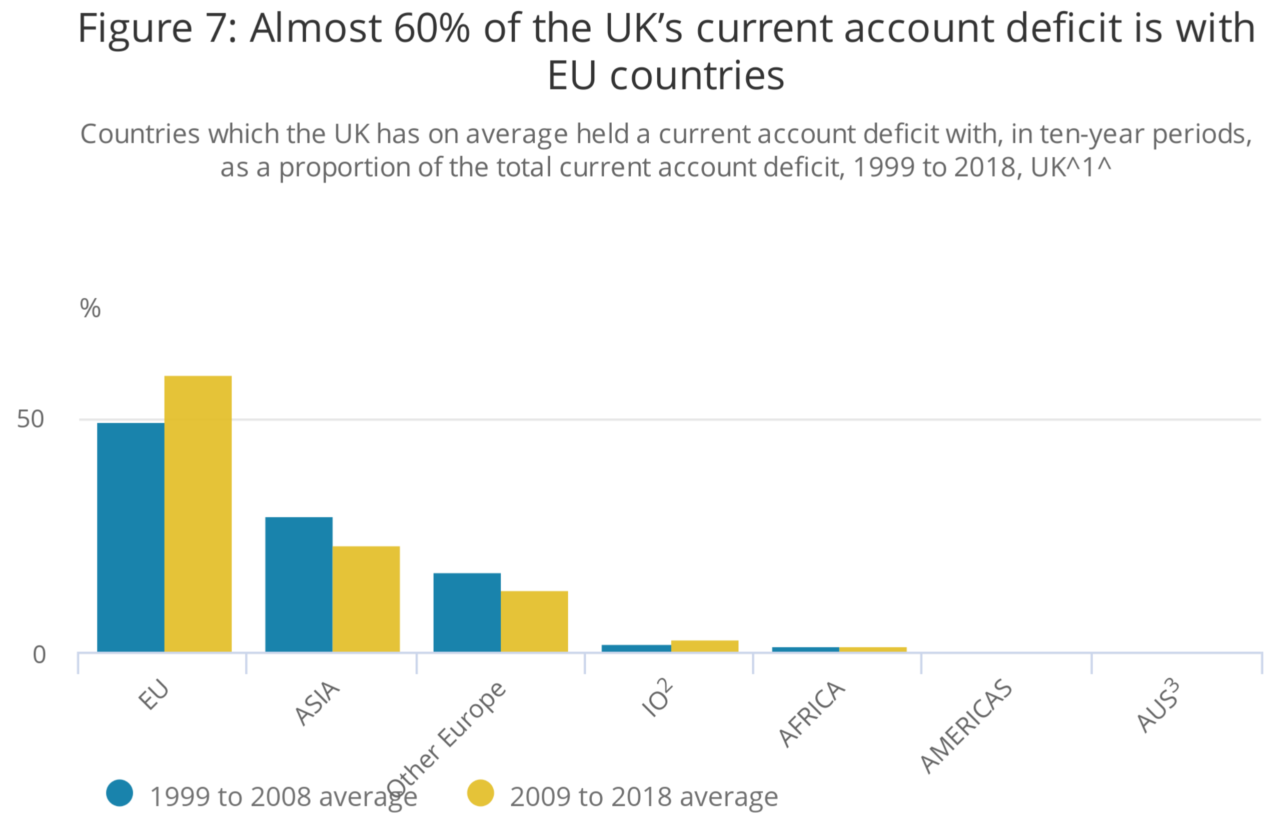
Notes:

1. Series YBHA used for nominal gross domestic product.

Between 1999 and 2008, out of all the countries that the UK held a current account deficit with, on average, almost 50% were with countries from the EU. In the decade after 2008, this proportion increased to almost 60% (see Figure 7), while deficits with Asian and other European countries proportionally decreased.

Figure 7: Almost 60% of the UK's current account deficit is with EU countries

Countries which the UK has on average held a current account deficit with, in ten-year periods, as a proportion of the total current account deficit, 1999 to 2018, UK[1]



Source: Office for National Statistics - Balance of payments

Notes:

1. Author's own calculations.

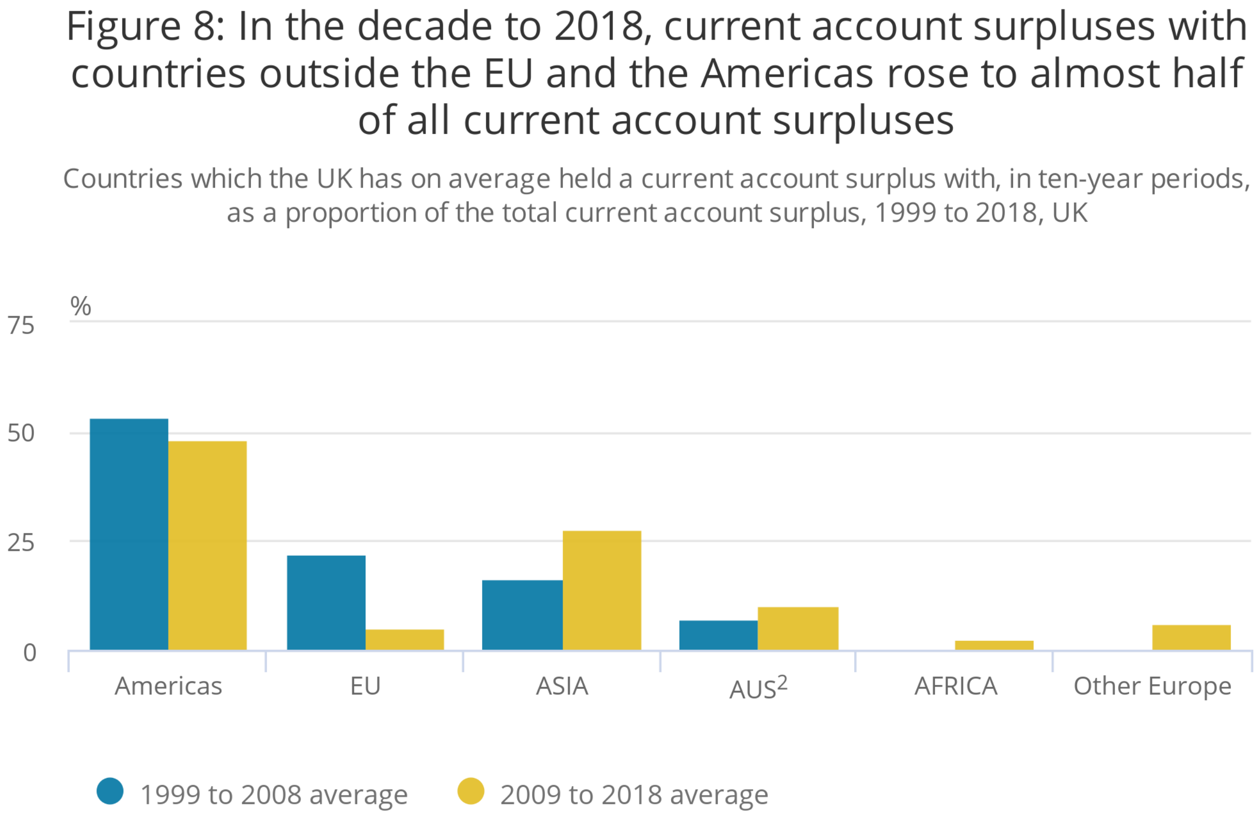
2. International organisations.

3. Australasia and Oceania.

Between 1999 to 2008, out of all the countries that the UK held a current account surplus with, on average, over 50% were with countries from the Americas (mainly the US). In the decade after 2008, this proportion decreased to below 50%, while the proportion of our surplus coming from EU countries decreased from over 20% to less than 5%, as Figure 8 highlights. Our surplus with Asian, Australasian, African and other European countries increased in the latest decade, compared with the previous decade.

Figure 8: In the decade to 2018, current account surpluses with countries outside the EU and the Americas rose to almost half of all current account surpluses

Countries which the UK has on average held a current account surplus with, in ten-year periods, as a proportion of the total current account surplus, 1999 to 2018, UK



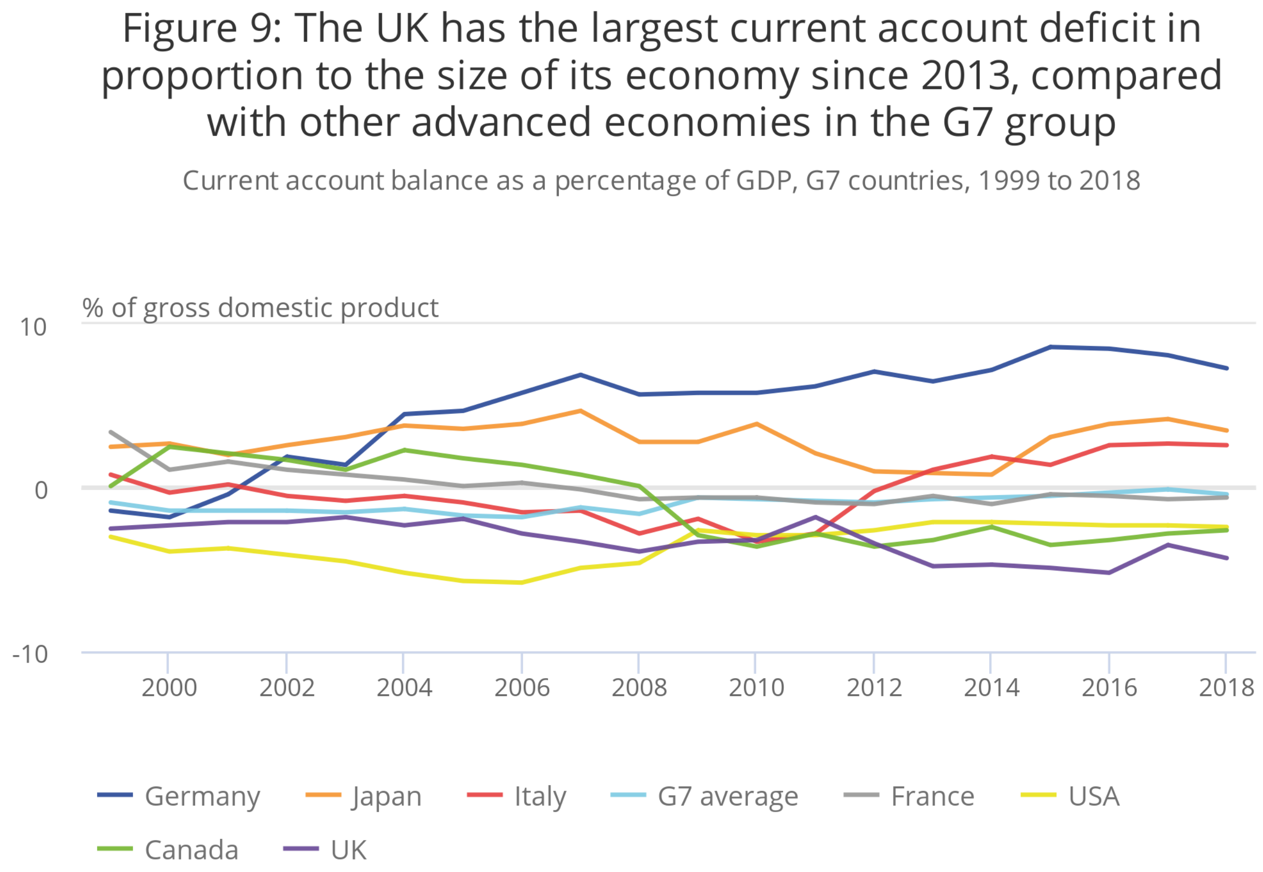
Source: Office for National Statistics - Balance of payments

Notes:

1. Author's own calculations.

Figure 9: The UK has the largest current account deficit in proportion to the size of its economy since 2013, compared with other advanced economies in the G7 group

Current account balance as a percentage of GDP, G7 countries, 1999 to 2018



Source: Office for National Statistics - Balance of payments, OECD

3 . How does the UK finance its current account deficit?

If a country's outgoings (debits) to the rest of the world are greater than its incomings (credits) from the rest of the world, then it is running a "current account deficit". In other words, there is a need to purchase foreign currency in order to meet these due payments to the rest of the world. To meet this need, the country in deficit has to either draw down on its financial assets (that is, sell assets) or incur liabilities (for example, a loan) from foreign institutional units such as foreign banks or foreign investors.

These financial necessities are ultimately reflected in the UK's international investment position (as published quarterly in the Balance of payments, UK Statistical bulletins) which saw significant deterioration between 2009 and 2015.

Over the last two decades, the UK has funded its current account deficit in various ways. From 2006, for example, the UK began experiencing a sustained inflow of foreign investment in UK debt securities such as bonds (in effect, providing the UK with foreign currency in return for owning UK bonds), while at the same time UK investors have held back from investing in debt securities abroad (in effect, keeping pounds in the UK). Similarly, from 2012 on, UK investors began holding back from investing directly in companies abroad via the purchasing of equity (shares) while foreign investors continued to invest in the UK (again giving the UK foreign currency in return for owning UK equity).

How does any of this relate to the common UK resident?

4 . The relationship with the national accounts

The current account balance (CAB) can be related back to the national macroeconomy and allows us to examine whether increases or decreases in the balance are caused by relative changes in national savings or investment factors. To illustrate the above, it is useful to define a few national accounting identities.

This article has outlined that a country's CAB consists of primary income (PI), secondary income (SI) and its balance of trade (NX):

(1) CAB=PI+SI+NX

To link this to the national macroeconomy, we can consider the main measure of the national economy – gross domestic product (GDP). GDP summarises the economy in terms of its total production of final goods and services and can be done via three different approaches: production, income, and expenditure. The expenditure approach to measuring GDP records the total amount of expenditure on final goods, which can be derived by summing total consumption by households (C), government spending (G), businesses investment (I), and net exports (NX):

(2) GDP=C+G+I+NX

Additionally, to calculate national savings (S), we need to capture national disposable income (gross national disposable income (GNDI)) before then subtracting the country's short-term expenditures such as consumption (C) and government expenditure (G):

(3) S=GNDI-C-G

Where GNDI considers national income (GDP), net income generated from cross-border investments (PI) and net cross-border transfers (SI):

(4) GNDI=GDP+PI+SI

Using these identities, we can rearrange to show that the current account balance can be expressed in the form of national savings and investment (CAB = S – I) that can help us to better understand which areas in the economy are being impacted in our relationship with the rest of the world.

For instance, knowing that:

(3) S=GNDI-C-G

Fully expanded using expressions (4) and (2), this becomes:

S=C+I+G+NX+PI+SI-C-G

This simplifies to:

S=I+PI+SI+NX

And using identity (1), this simplifies to:

S=I+CAB

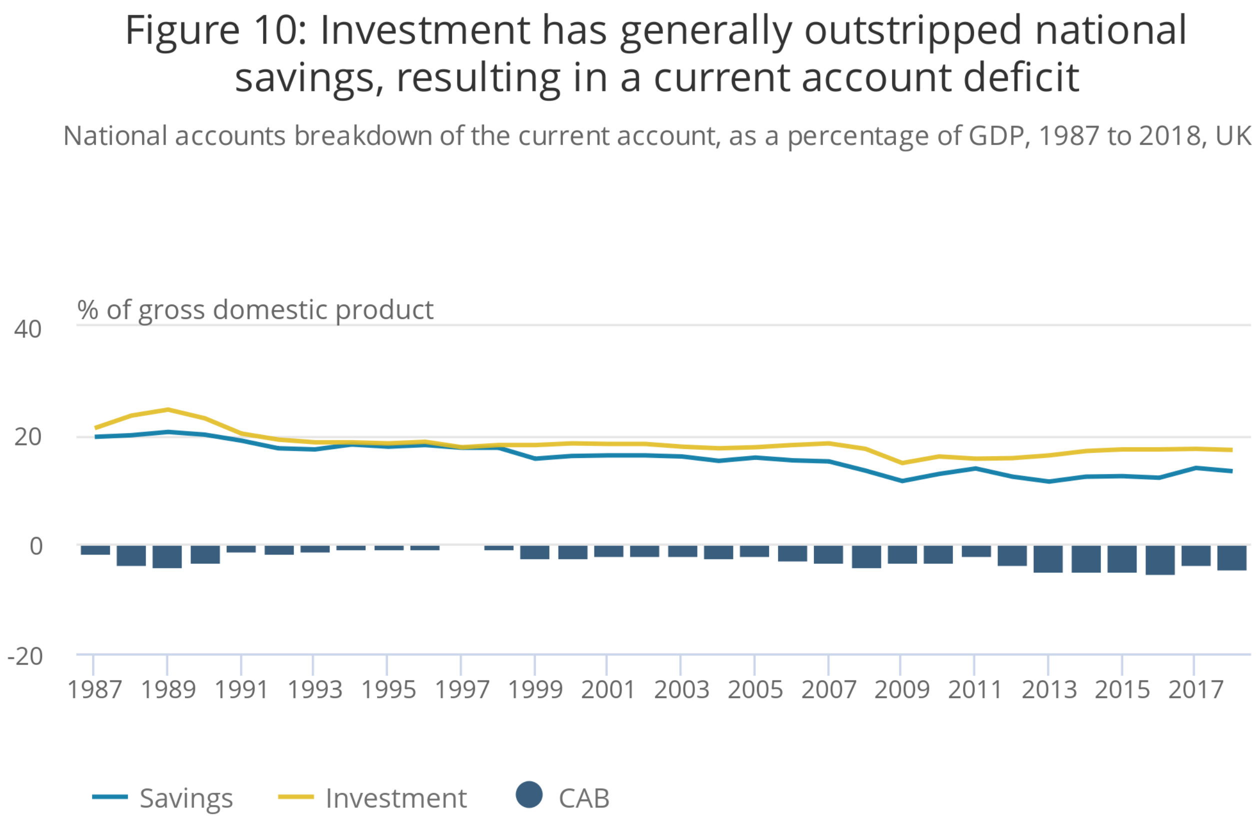
Therefore:

CAB = S - I

Figure 10 shows that the UK's recent historically high current account deficit (2012 to 2016) has partly been the result of a slight dip in national savings (as a proportion to the overall size of the economy), while investment grew before levelling off from 2014 to 2016. Between 2011 and 2018, savings increased by 25% whereas investment grew 42%. Investment can have positive long-term impacts by boosting productivity and long-term economic growth, however, the fact that national saving does not match investment highlights the need for financial assistance in the form of foreign investors.

Figure 10: Investment has generally outstripped national savings, resulting in a current account deficit

National accounts breakdown of the current account, as a percentage of GDP, 1987 to 2018, UK



Source: Office for National Statistics - (UK Economic Accounts)

Notes:

1. Series YBHA used for gross domestic product.

The Quarterly sector accounts, UK Statistical bulletins provide breakdowns into the investments and savings made by each domestic sector, allowing us insight into certain distributional elements of the current account.

5 . Does a current account deficit matter?

A current account deficit may not entirely be a “bad” thing. It could reflect a “well-off” society able to afford the luxury of importing goods and services from abroad, raising their standard of living. Furthermore, it may also reflect the perceived attractiveness of the country as a suitable destination for investment. Foreign investment creates jobs, can boost domestic incomes, tax revenues, and can have positive long-term effects on productivity and ultimately economic growth.

However, a growing and increasingly significant deficit (for example, in relation to the size of the country’s economy) may begin to suggest some warning signs. The deficit highlights a “leakage” of domestic currency to the rest of the world partly because of the requirement to purchase foreign currency to meet cross-border payment obligations (for example, imports). This mass purchasing of foreign currency (and therefore, selling of the domestic currency) can depreciate the value of that domestic currency if enough of this activity happens.

Furthermore, the significant ‘leakage’ of domestic currency could signal an unsustainable economic environment whereby the country may be dipping into its national savings to meet its cross-border payment obligations (as the previous section highlighted). Should this be the case, for example, and should foreign investors lose confidence and decide to pull out their investments from host country, a large sell-off of that currency may begin to take place and rapidly depreciate the value of the domestic currency. This could lead to a currency crisis that can have a negative and lasting impact on the common resident via the closure of businesses, loss of jobs, and a government financially struggling to minimise an impending economic downturn.

6 . Useful links

Further analysis on the latest balance of payments estimates (including the current account) can be found in the UK Balance of Payments, The Pink Book: 2019 published on 31 October 2019.

Further analysis on the UK National Accounts can be found in the UK National Accounts, The Blue Book: 2019 published on 31 October 2019.

7 . Acknowledgements

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