June 2005 Unit 6
Question 5

a) A deficit on the trade in goods and services simply means the UK is importing more than it is exporting. This deficit could be due to both private and govt spending. A fiscal deficit on the other hand is purely government. It means the govt is spending more than it earns in taxes. A fiscal deficit is usually financed through debt.

b) From Fig. 1 we can see that consumer debt expanded sharply in two periods. The first was from 1987 to 1990 and then again in 1997 to 2002.

One possible reason for this debt growth is because of ~~supp~~ sharply rising housing prices. This would influence debt in two ways. Firstly people wanting to buy houses may have to take out larger mortgages. Secondly people already owning houses may feel wealthier through capital appreciation and these people take out more debt because they feel more confident financially.

Another reason for rising debt is because of falling unemployment levels and rising incomes. Not only do people again experience a rise in confidence to take out debt because of higher financial security expectations but also working people are eligible for credit cards when unemployed people are not.

* Other reasons include:
  - falling interest rates.
  - increasing use of hire purchase schemes by retailers competing for consumers.

c) In 2000-01 the govt. enjoyed a fiscal surplus of approximately £20bn. By 2003-4 this had dissappeared and was replaced by a deficit of approximately £20bn. Obviously the government was spending more and/or taxing less. The ~~latter~~ former was the main reason.

Firstly after New Labour came into power, the new Chancellor laid out plans to increase govt. spending greatly by expanding hiring in the heath and education sectors. At the same time the govt had no plans to tax more. The deficit only manifested in late 2001-2 because of the lagged effect.

Also New Labour was serious about fulfilling their promise to eliminate poverty. To this effect they boosted cash benefits to people in relative poverty. Among the measures implemented included the Working Families

Tax Credit (WFTC) which is a top-up payment to households with at least one working adult whose incomes fall below a certain level. Another was the Minimum Income Guarantee (MIG) which is also a top-up cash benefit for pensioners which is indexed to average incomes rather than inflation.

However, despite the rising levels of employment, incomes have not risen significantly thereby keeping tax revenue growth below govt. spending growth. There may also be a lagged effect before the growth in govt spending raises incomes via the multiplier.

d) From Fig. 5 we can see that from approximately 1998, the UK began to experience a chronic and widening trade deficit. Fig. 3 shows this deficit to come mainly from the imports of goods with a small surplus in exports of services. Fig 4. shows that much of the deficit seems to come from Germany and China.

One possible and very significant cause of the deficit can be the rising value of the £ with respect to trading partner currencies. The £ began appreciating steadily from 1996 right through 2003. This fact makes UK exports expensive in foreign currency terms while imports become relatively cheap. Given that the sums of the elasticities of demand for exports and imports is greater than 1, the trade deficit will worsen with the £ appreciation. This was probably compounded by the fact that in '97 there was an Asian currency crisis which pushed the Chinese RMB to very low levels.

Helping the deficit growth is the loss of comparative advantage of UK's manufacturing industry. This is mainly due to relatively high labour costs and low labour productivity. UK manufactures also lost out in terms of quality and incorporation of newer technology. UK marketing also lags behind allowing foreign brands to entrench themselves in UK consumer psychos.

Finally we can point to accelerating globalisation as a contributing factor. For example many UK services like retail banking which is generally non-tradeable have begun to out-source some of their more labour intensive operations to cheap labour countries. As a result imports of serives like help-desk enquiries, web-site maintenance and even payroll management have increased.

However the decline in the trade balance may have been arrested in the last two years because oil prices have risen sharply. Since UK is a net exporter and the demand for oil is highly inelastic, this may bring in more export earnings.

e). If the £ depreciates, there will be both demand and supply side effects.

The immediate impact may actually fall on the rate of inflation. Because the basket of goods from which the RPI is derived contains many imported components - like consumer electronics and cars, a falling £ will mean the domestic price of these goods will rise. This may push inflation rates higher. However the extent of the domestic price increase will depend on the level of competitiveness of the retail sector. A competitive mkt will force retailers to absorb the rising cost with little effect on retail prices.

There will also be some impact on the trade balance. A depreciating £ will cause UK exports to become more competitive abroad while foreign imports become more expensive domestically. This should rationally improve the trade balance. However one must bear in mind the "J Curve" phenomenon. In the short run demand tends to be inelastic. Therefore the sums of elasticities of demand for exports and imports may be less than unity. In this case the depreciation will initially widen the trade deficit. However, with time elasticities increase as consumers and firms can adjust and the trade balance will gradually improve. Also we assume that the imports have local substitutes. Some like celular phones are not manufactured in the UK. In this case import expenditure may not fall even in the long run.

Finally a weaker £ will mean more expensive imported raw materials and unfinished components. Oil will also be dearer because prices are denominated in USD. This means production costs may rise resulting in cost push inflation. This may offset some of the GDP growth from growing net exports.

f) Rising interest rates will mean poorer households who have existing debt. Both Extract 1 and Fig 1 show that not only are more households taking out credit but they are on average taking out more credit per household. In 2002, consumer debt was at nearly 130% of disposable income. If say interest rates were to rise to 10% the household would be spending close to 13% of their incomes on interest payments alone, leaving less money left for consumption. Consumption spending would fall.

Consumers who are not burdened with debt may hesitate to take on debt. As such the purchase of durables like washing machines and cars will fall. Applications for mortgages will also fall.

Given the better return on their savings, households may choose to forgo consumption and save instead. This will also lead to a fall in consumer spending.

Taken together, the fall in consumer spending (being the largest component in AD) together will a fall in investment spending may cause unemployment to rise. This may lead to a further fall in consumption.

However some consumers who already possess savings such as pensioners, may find themselves enjoying higher interest incomes. These consumers may spend more. Also some consumers who find it difficult to repay debt may go further into debt. This will last a while before they become insolvent.