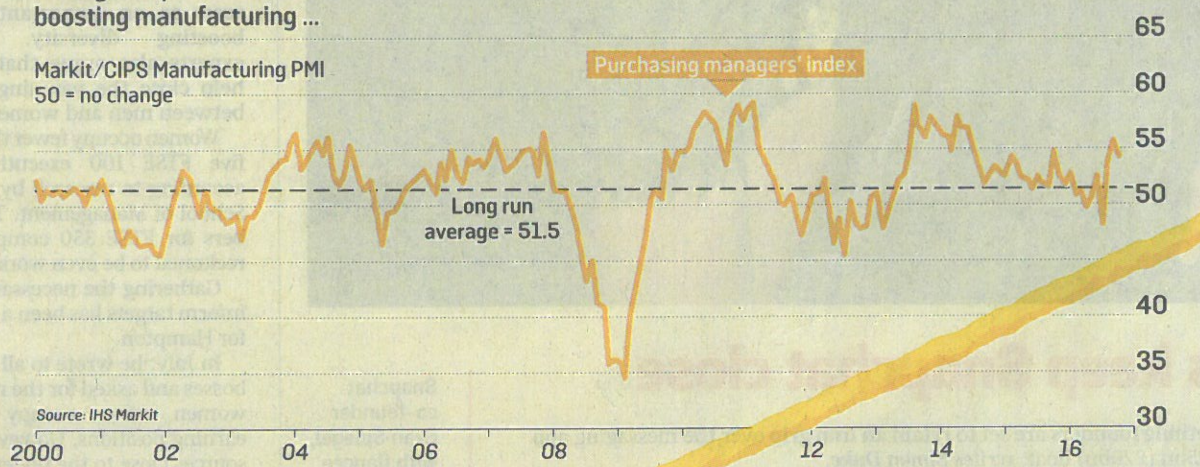

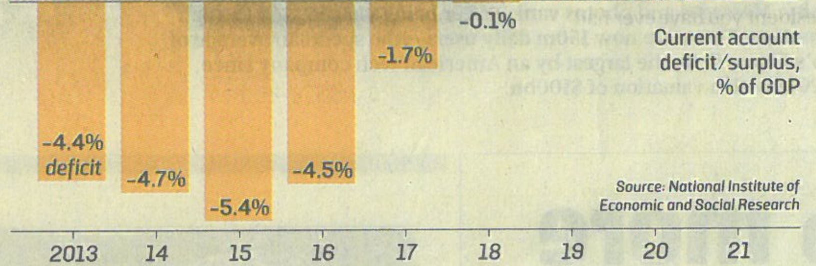

Sterling's ill wind could blow us back to balance

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ECONOMIC OUTLOOK

You would have to say it has been a bracing few months, particularly for the pound. Blown in one direction — sharply down — by the referendum result and government indications that it will be pursuing a harder form of Brexit, then blown back up a little — to $1.25 — by the High Court ruling last Thursday that parliament must have a vote on the triggering of the formal article 50 process.

But the pound remains very substantially lower than it was, which will have consequences, notably higher inflation. It is an ill wind, however, that blows nobody some good.

Manufacturers are clearly benefiting from weaker sterling. The latest purchasing managers' survey for the sector from Markit showed export orders are driving a mini-revival in our factories. That is good news, but far more remarkable is the possibility of one of Britain's long-standing Achilles heels being eliminated in just a few years.

I am referring to the current account deficit, or gap in the balance of payments — the amount that this country is in the red in its transactions with the rest of the world. It used to be regarded as the one of the best measures of the nation's economic health.

The deficit, as regular readers will know, has been running at record levels. Last year it was no less than £100.2bn, 5.4% of gross domestic product. In the first half of this year it averaged 5.8% of GDP. It was this that led the Bank of England governor Mark Carney to say that Britain would be dependent on the kindness of strangers to fund all this red ink.

The remarkable news, then, is that Britain may not be dependent on this kindness for too much longer. The latest forecast from the National Institute of Economic and Social Research (NIESR) attracted a lot of attention a few days ago average out at 4.5% of GDP, a small improvement on last year. Next year it predicts a bigger drop in the deficit, to 1.7% of GDP. It is what might happen next that really caught my eye, though. The deficit is predicted to virtually disappear in 2018, dropping to a mere 0.1% of GDP, but then to be followed by three successive annual surpluses of 1.2%, 1.2% and 0.9%.

Before explaining how this is expected to come about, it is worth taking a moment to record how unusual a single current account surplus would be, let alone three in a row. Britain has not had a single annual surplus in the past three decades. The Office for National Statistics' dataset, going back to 1987, shows that the nearest we had to a surplus was a 0.2% of GDP deficit in 1997. Last year, as noted, it was a record 5.4% of GDP. So this would be a very big change.

How does it happen? There are three main things happening in the NIESR forecast. Though it notes Britain's exports often respond disappointingly to falls in the pound — in the jargon, the elasticities are low — it expects some impact on export growth. But, as far as trade is concerned, despite post-crisis hopes of export-led growth, is forecast to make a significant positive contribution next year and beyond. The trade deficit in goods and services, £39bn last year, is predicted to disappear before the end of the decade.

The second big factor is investment income, which has been responsible for much of the lurch into record current account deficits in recent times. This was the phenomenon under which foreigners were earning larger returns on their investments in Britain than British people and institutions were doing on their investments overseas.

The lower pound affects this in two ways. It boosts the sterling value of foreign assets and thus improves Britain's net international investment position, while leaving the sterling value of foreign-owned assets here unchanged. It also boosts the value of foreign income. It is enough to return to surplus this component of the balance of payments, the so-called primary income account, perhaps even before the end of this year.

Finally, in what Simon Kirby at the NIESR admits might be a heroic assumption, another source of improvement is that Britain stops paying contributions to the EU in 2019-20. That assumes exit by March 2019, a date perhaps complicated by the High Court judgment, and assumes exit is not followed by the kind of arrangements Switzerland and Norway have with the EU, which involve contributions.

Anyway, the prospect of a return to surplus on Britain's current account, particularly from a position of record deficit, is encouraging. The Bank of England, by the way, also sees the deficit narrowing significantly but its forecast does not run as long as NIESR's.

Will it happen? Forecasts — good and bad — are forecasts, and subject to the usual health warnings. I had thought the big fall in the pound from the autumn of 2007 to early 2009 would lead to a significant forecast — $1.22 and €1.11 — which implies a prolonged period during which it is below both fair value and historical averages. Currencies move, as we saw last Thursday. Depending on what happens this Tuesday in America, the dollar could move quite a lot. Currency market indications in recent days are that it would fall a lot on a Donald Trump victory, pushing the pound higher.

There is also, of course, the elephant in the room of Britain's future trading arrangements. The NIESR expects the trade and current account positions to start deteriorating again in the first half of the 2020s. If Britain fails to secure good trade deals with the EU and the rest of the world, that deterioration could be very significant indeed. We should enjoy this return to surplus while it lasts.

PS Have we reached rock bottom for interest rates at 0.25%? Having said that it would consider a further cut before the end of the year when it reduced them to that level in August, the Bank predictably left well alone last Thursday in the light of stronger data than it had expected. Its stance now is determinedly neutral; it could cut again if economic weakness requires it. Equally — and this was a change — it will raise rates if it thinks higher inflation is becoming embedded.

Despite an upward revision to growth and inflation next year, the Bank's latest assessment is a gloomy one. Growth of 2% or so feels like proper growth, but the Bank does not expect that to occur in the three years 2017-19, with predictions of 1.4%, 1.5% and 1.6% respectively. Meanwhile, it says, inflation will move above the 2% target and stay there; 2.7%, 2.7% and 2.5% respectively.

The falling pound is one reason for the rise in inflation, but there are also what the Bank describes as supply developments, which will also bear down on growth. It takes the view that Brexit uncertainty will