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Tullett Prebon Research, a blog by Dr Tim Morgan

Living on tick – some stark warnings

by Tim Morgan on April 2, 2013

Though largely ignored by the media, the latest full-year current account data reveals some very disturbing trends in Britain's financial relationship with the rest of the world. The cost of essential imports (such as energy and food) is rising inexorably and, together with interest on government debt, cost about £57bn last year. Against this, earnings from financial services have declined, and net investment income has crashed, reducing inflows from these sources to £46bn in 2012 from £73bn in 2011. These patterns – which contributed to an alarming current account shortfall of £58bn in 2012 – are already unsustainable, yet seem destined to worsen.

Probably because the full-year number could be anticipated based on quarterly data, publication of the 2012 current account balance went largely unnoticed both in the media and the markets. This oversight is mistaken, for Britain's financial relationship with the rest of the world is deteriorating alarmingly. In comparison with a 2011 shortfall of £20bn, the current account deficit crashed to £58bn last year, equivalent to 3.7% of GDP and one of the worst results ever recorded. Bad though this number is, the trends which contributed to it are even more disturbing. Examination of the data suggests that both interest rates and the cost of essential imports are emerging as key risk-factors.

Put simply, the current account combines trade and capital-related flows. Within the £36bn deterioration recorded last year, a worsening trade deficit accounted for £12bn (equally divided between goods and services), and capital-related sums were responsible for the other £24bn.

At £37bn, the trade deficit was not particularly out of line with that recorded in 2007 (£38bn), but both the context and the composition of this number have changed very materially. For a start, the 2007 number reflected an economy which, powered by a debt-driven "boom", was sucking in a lot of consumer goods. In 2007, the deficit in goods other than food and energy was £68bn, a number that was little changed (at £66bn) in 2012 (because devaluation has not supplied the much-anticipated export boost). On the other hand, Britain's deficit in energy and food has increased sharply since 2007. The take-away point here is that Britain was much more dependent on net overseas supplies of food and energy in 2012 (£40bn) than in 2007 (£23bn), let alone 2002 (£4bn).

Over five years, net exports of services have improved – rising to £70bn last year compared with £53bn in 2007 – but 2012 itself saw a significant (£6bn) deterioration. This mirrors the trend in financial services, where net exports remain £3bn higher than in 2007 but have declined by £6bn since 2008. Here, the key point is that we seem to be witnessing a weakening in net service exports, particularly in finance, hitherto the mainstay of Britain's export revenues.

The big change in 2012, though, wasn't the £12bn deterioration in trade but the £24bn slump in capital-related income. Much of this slump is likely to have occurred in the banking sector, where overseas lending has become both smaller and less profitable. The other big number to take into account is the payment of interest to foreign owners of gilts, a number which

didn't increase by very much in 2012 but has, of course, risen markedly over the last decade.

Put very simply, the big numbers for 2012, starting with the credit side of the ledger, were net exports of financial services (£45bn), net exports of other services (£25bn) and net investment income (£2bn). Together, these totalled £72bn last year, down from £102bn in 2011. On the debit side, the big outgoings totalled £123bn – up by £6bn – and included significant, unavoidable outflows such as government debt interest and net imports of food (£19bn), energy (£21bn) and other goods (£66bn).

Bad though the latest figures are, the real cause for concern has to be the likely direction of travel of these big-ticket items. Given probable price trends, the escalation in energy and food import costs is likely to continue, whilst government debt interest payments will increase as well. Within a banking sector torn between pressures to increase both its capital ratios and its domestic lending, there would seem little likelihood of an improvement in income, even if it were not for the sector's recent reputational damage.

In short, last year's alarming £57bn net outflow may be the shape of things to come, but, to state the obvious, the UK cannot expect foreigners to continue to fund 3.7% of our economy as well as making material contributions to our inveterately over-spending state.

If this points – as it very well might – to problems in the markets, investors would do well to ask themselves what would happen to the British economy if it were hit by the double-whammy of (a) higher interest rates and (b) costlier food and energy. This is what will happen unless we – meaning both the government and the economy as a whole – learn to live within our means.

£bn	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Income						
Financial services	+£42	+£51	+£49	+£45	+£47	+£45
Other services	+£11	+£10	+£14	+£22	+£29	+£25
Investment income	+£19	+£32	+£18	+£15	+£26	+£2
	+£72	**+£93**	**+£80**	**+£82**	**+£102**	**+£72**
Expenses						
Food imports	-£15	-£17	-£18	-£17	-£18	-£19
Energy imports	-£8	-£14	-£9	-£10	-£19	-£21
Imports of other goods	-£68	-£63	-£57	-£71	-£63	-£66

Government	-£10	-£9	-£11	-£15	-£16	-£16
	-£100	**-£103**	**-£94**	**-£113**	**-£117**	**-£123**
Subtotal	-£28	-£10	-£14	-£32	-£15	-£51
Other, net	-£4	-£5	-£4	-£6	-£6	-£7
Current account balance	**-£32**	**-£14**	**-£18**	**-£37**	**-£20**	**-£58**

Source of data: ONS