

Will the trade deficit improve?

Instructions:

This article is designed to illustrate the idea that exchange rates don't always have the impact on the trade balance that might have been expected. Probably works best as a paired exercise initially at least. Show the students the article by either printing this document or by using the digital resource and then ask them to think about the two questions.

U.K. Trade Deficit Widens, Manufacturing Output Drops To Add To Uncertainty

U.K.'s trade deficit widened and manufacturing production dropped in January, despite the pound's depreciation, adding more uncertainty to the British economy's outlook.

Goods trade deficit narrowed to 8195 million pounds in Jan. from 8738 million pounds in Dec. as exports fell 3.5 percent to 24.8 billion pounds, while imports declined 4.2 percent.

Services trade deficit reached 5.83 billion pounds while total trade deficit reached 2.36 billion pounds.

It seems that the U.K. is not able to benefit from the pound's drop versus euro and dollar, with sterling having fallen sharply since the start of the year, trading at a 16-month low against the euro. The pound is also at its lowest level against the dollar since June 2010.

Adapted from:

<http://www.actionforex.com/analysis/daily-forex-fundamentals/u.k.-trade-deficit-widens,-manufacturing-output-drops-to-add-to-uncertainty-20130312185694/>

1) Why might this be considered as odd?

2) Come up with at least 3 reasons that it might have happened.

Will the trade deficit improve?

Possible answers:

- 1) Economic theory suggests that a fall in the exchange rate should in principle lead to an increase in the value of exports and fall in the value of imports in sterling terms (because P_x falls in foreign currency terms and P_m rises in sterling terms).
- 2) Elasticity – nature of imports and exports, recession in overseas markets, time lags – not easy or desirable to switch suppliers based on short term fluctuations in exchange rates.