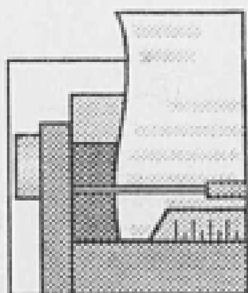
PERSONAL VIEW

Emu is no cure for problems with the balance of payments

By Tony Thirlwall



In a world of many currencies, a country's balance of payments problem is essentially a foreign exchange problem. For a specified growth of output and unemployment level it cannot earn enough foreign exchange from exports to pay for required imports at a given exchange rate. There must either be continual borrowing, or something has to give: growth, employment or the exchange rate. In this sense, Britain has been plagued by balance of payments problems for years.

Does this mean that if Britain joined a European monetary union with a single currency its balance of payments difficulties would vanish overnight? It is true that there would be no exchange rate to defend but there would still be imbalances between exports and imports which would not be naturally or easily put right by private lending and investment, or by inter-regional fiscal transfers in a federal union.

Those who say balance of payments problems would disappear draw the analogy with regions of a country using a single currency. We don't talk about the balance of payments difficulties of Scotland, Wales and the north of England, or of Sicily and Apulia. But this does not mean they don't exist. Any shortfall of a region's exports below its planned level of imports will manifest itself in slow growth, high unemployment and depressed economic conditions in general, unless its goods and services can be made more competitive through subsidies or the region receives capital inflows in the form of private sector lending or government fiscal transfers.

While it is true, therefore, that the movement from a multiple currency system to a single currency does away with the outward manifestation of balance of payments difficulties because there is no exchange rate to defend and foreign currency reserves become irrelevant, the inward manifestation of balance of payments deficits remains.

Samuel Brittan recently argued (Economic Viewpoint, June 27) that "the ability to dump the balance of payments problem once and for all is among the greatest but least emphasised advantages of Emu". In playing down the importance of the balance of payments for the healthy functioning of the real economy, he refers to the absurdity of treating trade between Sussex and Normandy entirely differently from trade between Sussex and Yorkshire when all three regions are supposed to be in a single market. He recognises that some balance of payments problems will reappear in regional form inside a monetary union.

These issues lie at the heart of the debate over sovereignty now generating so much excitement within the European Community.

Yet there *are* good reasons for treating trade between Sussex and Normandy differently from trade between Sussex and Yorkshire. First, Britain as a nation state may feel a responsibility for the residents of Sussex that it doesn't feel for Normandy. Second, it may feel capable of dealing with disparities between Sussex and Yorkshire through its own internal fiscal system in a way that could not be guaranteed if the viability of Sussex was being threatened by the superior competitiveness of Normandy within a monetary union.

In some circumstances, the exchange rate could be a useful weapon for protecting the inhabitants of Sussex.

The issue of the balance of payments goes deeper, however, than the question of the exchange rate alone. The role of the balance of payments in accounting for inter-country growth rate differences has been ignored for too long by orthodox economic theory which in the pre-Keynesian days argued that the balance of payments, like everything else in the economic system, was self-adjusting through the price mechanism, and then in the 1950s analysed growth performance from the supply side with no reference to demand.

The Keynesian revolution didn't help because Keynes's model was static and dealt for the most part with a closed economy. The emphasis on the imbalance between savings and investment diverted attention from the greater potential imbalance between exports and imports which in the real world may be harder to rectify. A strong export performance relative to import demand is vital to the strength of aggregate demand in the system as a whole, single currency or not.

Some economic sovereignty would be lost by movement to a single currency, but much more was lost when Britain joined the EC in 1971. The ability to protect and encourage strategic industries has gone; the possibility of designing systems of managed trade to even out payments imbalances has gone; the ability to protect against certain countries with persistent surpluses has been taken away; differential taxes which discriminate in favour of the tradeable goods sector fall foul of the Treaty of Rome.

Britain's balance of payments is chronically weak. High interest rates are required to finance deficits that arise when the country attempts to grow at no more than 1 or 2 per cent a year, which then further damages the real economy.

Three centuries ago the mercantilists recognised this dilemma with great clarity, and so did Keynes in his defence of mercantilism against the classical free traders who treated the mercantilists as "imbeciles" (Keynes's word). As Keynes rightly recognised, the interest rate required for external balance may be out of line with that required for internal balance. That problem also doesn't go away in a single currency area with depressed regions (or countries) competing for investment funds.

Britain needs all the monetary and fiscal instruments it can muster to break 40 years of weak balance of payments, slow growth, depressed demand, de-industrialisation leading to further balance of payments weakness. To believe that weak export performance, import penetration, the deterioration of the industrial base leading to slower growth and rising unemployment would disappear with a single currency is to turn economics into a branch of theology.

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