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Ignore the Trade Balance: Concentrate on Full Employment

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> "But if nations can learn to provide themselves with full employment by their domestic policy (and, we must add, if they can also attain equilibrium in the trend of their population), there need be no important economic forces calculated to set the interest of one country against that of its neighbours. There would still be room for the international division of labour and for international lending in appropriate conditions. But there would no longer be a pressing motive why one country need force its wares on another or repulse the offerings of its neighbour, not because this was necessary to enable it to pay for what it wished to purchase, but with the express object of upsetting the equilibrium of payments so as to develop a balance of trade in its own favour. International trade would cease to be what it is, namely, a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle, but a willing and unimpeded exchange of goods and services in conditions of mutual advantage" (Keynes 1936, chapter 24).

The orthodox theory of international trade is based, among other things, on the misleading assumptions that trade between nations will balance over time, and that in the long run at least, there would be full employment everywhere.

Since neither of these assumptions is remotely valid, some countries have chosen to pursue mercantilist export-led development strategies, based on the pursuit of persistently large trade surpluses, as a root to full employment, and a means of accumulating net foreign assets over time.

Others have faced persistent trade and current account deficits, which have apparently constrained macroeconomic management, and led to policies which have unnecessarily caused and maintained mass unemployment and underemployment, as a means to limit domestic absorption and limit trade deficits to what has been deemed sustainable levels.

A monetary sovereign government can achieve and maintain full employment without seeking to run a trade surplus, and a trade surplus is never a valid policy objective for such a government: a monetary sovereign government cannot be frustrated in its pursuit of full employment by a trade deficit, and a trade deficit is never a constraint on the pursuit of equitable, sustainable full employment.

This note explains that the current account balance of a country with a monetary sovereign government, like the fiscal balance of that government, is never an appropriate statistic to use as a policy target, and that the current account balance should be allowed to find its own level, depending on the behaviour of the foreign and domestic private sectors of the economy.

One of the most controversial issues among progressive economists over many years has been the trade balance, or more correctly, the current account balance on the balance of payments of an economy with a monetary sovereign government.

Are trade imbalances a matter of concern? Does a need to avoid a growing current account deficit impose a speed limit on the rate of economic growth which can be sustained (as suggested in Thirlwall 1979)?

Does it make sense to aim for a close to zero current account balance, so that you in effect 'balance the national budget' relative to the rest of the world? Does this imply a limit to the fiscal deficit which a government can maintain, even when an economy is far from full employment? Does it justify the imposition, or re-imposition, of tariff barriers and other limitations on international trade, as part of a fight for good-paying jobs, against countries which are pursuing unfair trade policies and manipulating their currencies? Is the only effective solution something like Keynes' proposal for a bancor, or Davidson's International Money Clearing Unit, to ensure that a global deficiency of effective demand does not consign many countries to mass underemployment (Davidson 2007, chapter 10)?

For a country on a gold standard, in a currency union, or seeking to maintain a fixed exchange rate, the answers to the above questions are far from simple. In the Euro-zone, for example, the growing current account imbalances that followed the formation of the currency area were a signal of increasing financial fragility within the system (Mitchell 2015, 240). For a country seeking to maintain a fixed exchange rate against the dollar, or against any foreign currency or basket of currencies, a growing current account deficit indicates the potential for a speculative attack on that currency, the depletion of foreign exchange reserves, and the variety of adjustment costs, which follow a forced devaluation. Such countries, of course, do not enjoy full monetary sovereignty.

The case of an economy with a monetary sovereign government is very different. Monetary sovereignty involves having your own currency and central bank, not being on a gold standard, not being on any kind of fixed exchange rate system, and not having significant foreign currency debt. Under these circumstances, it is no longer clear that a current account surplus is beneficial and a deficit costly, and indeed, the opposite may be true, however provocative though the claim may appear.

After all, the ultimate purpose of production, notwithstanding the wide variety of benefits we enjoy due to the opportunity to participate in rewarding paid employment, must be consumption, now or in the future. It is not clear that the main benefits derived from the productive activity of workers in the export sector of low income countries whose output is eventually sold cheaply to consumers in high income countries are enjoyed by those workers. If a young Chinese woman assembles a product which is then purchased for a low price and used by an American consumer, the benefits go to the consumer – not to the producer. If, down the years, surplus countries, like China, have used real resources to produce goods they have then exchanged with deficit countries, like the USA, in return for tokens in the form of US dollars, which is all that US government securities are, then the benefit lies with the net importer, and not the net exporter (as argued, for example, in Lawn 2011).

Domestic Consumption (plus additions to real assets) = Production + Imports – Exports

Imports are a benefit; exports are a cost. This is not to say that the pursuit of the maximum possible trade deficit should be a policy target. It is to suggest that, for many countries, the trade and current account balances should be left to find their own level, as the government concentrates on the maintenance of full employment.

This approach to the costs and benefits of trade provides an opposite perspective to a focus on the national income accounting aggregates, where the emphasis is on production rather than consumption, so that of course net exports are a positive, rather than a negative. Even the Genuine Progress Indicator (GPI), with its emphasis on consumption adjusted for a variety of social costs and benefits, views a negative current account balance as a bad, since it is interpreted as adding to a debt that future generations must repay (Hamilton and Saddler 1997). A current account deficit certainly does add to the negative nominal net international investment position of a country, but whether this can necessarily be seen as a debt to the rest of the world which will have to be repaid is open to question.

The currency in which a country accumulates net foreign liabilities over time is of vital importance. If public and private foreign debt is denominated in foreign currency, this creates the risk of national insolvency and a costly financial crisis. It also implies that the government of that country does not enjoy full monetary sovereignty, especially if the foreign currency debt is public debt, or effectively guaranteed by the public sector.

If the rest of the world has chosen to net save in the currency of a country, however, it is not clear that the resulting net foreign liabilities are a debt which needs to be repaid using real resources at all. This is at most potentially the case. The accumulation of domestic currency financial assets by the foreign sector is a portfolio decision of the foreign sector, and not something that the government can control precisely, or arguably should seek to control, except in so far as speculative capital flows are viewed as destabilising to financial markets.

Net capital inflows are then just the counterpart of a current account deficit. They create a demand for domestic currency from foreign exchange market makers, or prevent the sale of domestic currency to market makers on the part of foreigners in receipt of domestic currency relating to import sales, and sustain the external value of the domestic currency higher than it would otherwise be. Therefore, they influence the ability of foreign and domestic producers to compete on price both at home and overseas, and drive the current account balance. Under floating exchange rates, for all currencies which are heavily traded on the foreign exchange market, financial flows are the dog and trade flows are the tail, these days. Real exchange rates reflect movements on the capital and financial account, and the current account balance is largely the result of portfolio decisions.

Using the familiar three-sector financial balances model,

Private financial balance + Foreign financial balance + Public financial balance = 0.

At full employment, and given the net saving decisions of the private sector and the portfolio preferences of the foreign sector, the private and foreign financial balances are to a large extent beyond the control of the government. They can be influenced in a variety of ways, and central banks often aim to influence them using monetary policy, but they cannot be controlled.

The foreign financial balance, also known as the current account deficit, can and should be allowed to vary over time. Just as it is inappropriate for a monetary sovereign government to pursue a fiscal surplus, or a balanced budget, or any specific fiscal outcome, taken out of context, it is inappropriate for a monetary sovereign government to pursue a current account surplus, or balanced trade, or any specific current account outcome.

As for the sustainability of such an approach, exactly the same mathematics applies to the ratio of a country's external debt to its income, as applies to the ratio of its government debt to its income (Wray 2012, 74). Any trade deficit as a constant share of GDP will have some steady state external debt/GDP ratio associated with it, as long as the average rate of interest paid on that external debt does not exceed the growth rate of GDP itself. For a monetary sovereign, the principal determinant of the rate of interest offered on its external liabilities is the official rate of interest set by the central bank. The natural rate at which this should be set is zero.

So what exactly are economists who are concerned about the current account deficits of countries such as the UK, Australia, and even the USA, worried about? Not, I think, the potential for the trading partners of those countries to start using their sterling, or Australian dollar, or US dollar assets to purchase real goods and services, thus potentially adding to inflationary pressures in those countries. Very often those economists interpret such export sales as beneficial and job creating.

The concern is for a sudden reversal of capital flows, leading to a significant currency depreciation, a rise in the cost of imported goods (particularly where those goods are necessities priced in foreign currency), a decrease in real incomes domestically, and the potential for a resulting social-conflict driven cost-push inflation. A degree of elasticity pessimism regarding the impact of movements in exchange rates on trade volumes enhances this concern, in that it places the burden of adjustment more heavily on domestic expenditure reduction or real incomes, and less on expenditure switching in reaction to changes in relative prices.

It is possible, if unlikely, that such an outcome might eventuate. A decrease in the external value of a currency does necessitate a decrease in domestic real incomes, depending among other factors on the openness of the domestic economy, on price and cross elasticities and on exchange-rate pass-through effects. However, the potential for this to feed a continuous inflation depends on domestic institutional design, on issues like index-linked contracts, and on the existence or otherwise of competent macroeconomic management. Given a job guarantee is in place, it poses no threat to the maintenance of tight full employment, or to monetary sovereignty.

If significant and unhedged foreign currency denominated public and private debts exist; if a country is reliant on imports priced in foreign currency and on a narrow range of commodity exports with volatile prices; if labour market and other institutions are designed to turn one-off changes in the price level into episodes of continuous inflation; if private sector debt has been rising rapidly; and if banks and financial markets are not well regulated and supervised, then a growing current account deficit might eventually be a trigger for a severe currency depreciation, and a financial crisis.

However, these all represent structural or institutional problems in the domestic economy which need to be addressed. They do not justify a general conclusion that a monetary sovereign government should adopt a specific target for its country's external balance.

Governments should concentrate on the maintenance of an effective demand for labour which is sufficient for non-inflationary full employment. To do this, they should employ a bottom-up fiscal policy based on a comprehensive, permanent job guarantee scheme.

The fiscal balance matters, but not because the avoidance of a fiscal deficit is an appropriate target, and indeed when the non-government sector wishes to net save at full employment, the fiscal balance will be negative and – taken out of context – that is not a matter for concern.

The current account balance matters, but not because the avoidance of a current account balance is an appropriate target, and indeed when the foreign sector wishes to net save in domestic currency, then the current account will be in deficit and – taken out of context – that is not a matter for concern.

So the current account balance of the United Kingdom (standing at 5.2% of GDP, in 2016 Q3) should not be seen as an excuse for opposition politicians to ignore modern monetary policy, or to reject the use of functional finance to achieve and maintain full employment. Chinese exports to the USA do not provide an excuse for President Trump to argue that US jobs have been stolen, and a trade war with China is not necessary to restore American full employment. The fact that Australia has had a current account deficit on its balance of payments continuously for more than 40 years has not led to an explosive increase in the country's net foreign liabilities and will not restrict the ability of a future Australian government to introduce a job guarantee. All are monetary sovereigns. All are in a position to deliver equitable and sustainable full employment, regardless of the fiscal implications or the trade balance.

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