GERRARD & NATIONAL

Monthly Economic Review

No. 7, January 1990

Contents | Page no.

Commentary on the economic situation	1
Summary of research paper	2
Research paper - Topic: Does a private sector deficit matter?	3
Statistics this month - Calendar of UK and US release dates	*Outside back cover*

The Gerrard & National *Monthly Economic Review* is intended to encourage better understanding of economic policy and financial markets. It does not constitute a solicitation for the purpose of sale of any commodities, securities or investments. Although the information compiled herein is considered reliable, its accuracy is not guaranteed. Any personal using this *Review* does so solely at his own risk and Gerrard & National shall be under no liability whatsoever in respect thereof.

Gerrard & National Holdings PLC

Gerrard & National Limited   Gerrard & National Securities Limited

33 Lombard Street, London EC3V 9BQ Tel: 01-623 9981 Tlx: 883589 Fax: 01-623 6173

GNI Limited
Colechurch House,
1 London Bridge Walk,
London SE1 2SX
Tel: 01-378 7171
Tlx: 884962
Fax: 01-407 3848/9

Gerrard Vivian Gray Limited
Burne House,
88-89 High Holborn,
London WC1V 7EB
Tel: 01-831 8883
Tlx: 887080
Fax: 01-831 9938
Stx: 47377

Gerrard & National (Asia) Limited
Dina House, 5th Floor,
9-11 Duddell Street,
Central, Hong Kong
Tel: (5)845 1008
Tlx: 66915
Fax: (5)845 2058

Commentary on the economic situation

Will 1990 see the end of the great credit boom?

The 1980s will be remembered as a decade of remarkable growth in all forms of credit. The explanation is largely to be sought in the removal of various official restrictions on lending which dated back, ultimately, to controls introduced in the Second World War. The two most important measures of liberalisation were the abandonment of the so-called "corset" on bank balance sheets in the summer of 1980 and the ending of the informal Bank of England guidance against bank mortgages at some point in late 1981 or early 1982.

Since most financial deregulation occurred in the early 1980s, it is perhaps surprising that credit growth was most rapid during Nigel Lawson's years as Chancellor, which began in 1983. In 1980 new bank and building society lending totalled £15.7b.; in 1983 the figure was £24.0b. But then in 1985 bank and building society lending reached £34.4b., in 1986 £47.1b., in 1987 £53.3b. and in 1988 £82.0b. It was this credit surge which, more than anything else, was responsible for the upturn in monetary growth from late 1985, the boom of mid-1986 to mid-1988 and the return of inflation and balance-of-payments worries from late 1988. Having let credit rip for so long, the Government had to raise interest rates to 15% to bring the situation back under control.

One of the reasons for official dilatoriness in raising interest rates was a view that credit demand was insensitive to interest rate changes. Indeed, the dominant motive for the interest rate increases after mid-1988 was the need to protect sterling on the foreign exchanges rather than a wish to curb credit growth as such. However, it is encouraging to report that several straws in the wind now point to a definite slowdown in credit growth in early 1990.

The clearing banks' mortgages approved in the third quarter 1989 amounted to £1,498m., 56% less than in the third quarter a year earlier; the volume of leasing business (which often requires bank credit) fell by 2% in the third quarter, for the first time in many years, according to the Equipment Leasing Association; leveraged buy-out deals are proving difficult to syndicate after the disasters of the Magnet, Lowndes Queensway and MFI deals, according to *The Independent* (11th December); and a November survey by Woolgate Property Finance (reported in the *Financial Times*, 8th December 1989) found a significantly lower proportion of respondents in the property sector expecting to increase their bank exposure than a year earlier. The mass of evidence is difficult to dispute. Early 1990 will see a decline in the lending trend and a genuine moderation in broad money growth. It will be nice to enter a new decade without saying, once again, that credit growth is still accelerating.

Tim Congdon 18th December 1989

Summary of paper on

'Does a private sector payments deficit matter?'

Purpose of the paper A major public debate has developed about the significance of the UK's large current account deficit. It has been argued - notably by Mr. Samuel Brittan in the *Financial Times* - that the deficit should not cause concern, because the Government has a budget surplus and the external deficit must therefore reflect private sector decisions. (Mr. Brittan has called this view the "Lawson-Burns doctrine", as it was adopted by the former Chancellor to defend his policies.) The argument that a private-sector payments deficit is not a policy problem was first set out in detail in a paper, 'A new approach to the balance of payments', by Tim Congdon in *Lloyds Bank Review*, October 1982. Since the payments deficit is likely to remain substantial for the foreseeable future, the debate will continue and we thought it appropriate to re-publish the 1982 paper.

Main points

* **The transactions which determine the current account of the balance of payments can be regarded as the result of public and private sector decisions. It can be argued that private sector decisions to borrow and lend across frontiers (which may cause a current account deficit) are no more a matter for government concern than private sector decisions to borrow and lend within a country.**

* **If a private sector payments deficit is not a policy problem, a payments deficit can be a policy problem only if it is the result of the government's actions (i.e., because there is a budget deficit which cannot be financed from domestic sales of public sector debt).**

* **There is no such thing as "balance-of-payments policy" distinct from fiscal policy. Devaluation and import restrictions ease a payments problem only to the extent that they change fiscal variables.**

* **The punchline of the paper comes as the very end, that "As long as the public sector borrowing requirement is a low and declining proportion of national income, Britain will not suffer from a balance-of-payments problem."**

This paper was written by Tim Congdon. We are grateful to Mr. Christopher Johnson of Lloyds Bank for permission to reprint the 1982 paper. (The paper is also to be reprinted in a volume edited by Mr. Johnson *Changing Exchange Rate Systems*, to be published by Pinter Publishers in January 1990.)

Does a private sector payments deficit matter?

Reprint of Tim Congdon's paper "A new approach to the balance of payments", originally published in *Lloyds Bank Review*, October 1982

The critical point of departure

The balance of payments remains in the front of policy-makers' attention in many countries, particularly in the Third World. Discussion has been given new urgency by the prospect of default by sovereign borrowers, unable to repay substantial bank debts incurred in the 1960s and 1970s. As these practical problems have been subjected to considerable theoretical analysis, it may seem surprising that there is anything novel to say. However, the argument of this article is that valuable insights can be gained by a new method of formulating the balance of payments. The critical point of departure from previous work is to divide the economy into the public and private sectors, and to assess their contribution to a nation's overall balance of payments separately. By suggesting that a deficit incurred by the private sector results from freely taken decisions by individuals and is not a problem for policy-makers, the spotlight is turned onto the deficit incurred by the public sector. A government's payments difficulties are interrelated with fiscal and debt management problems. Indeed, we shall claim that the central misunderstanding of traditional theories has been to regard the balance-of-payments problem as distinct from the problems of the budget deficit and government debt sales. The provocative conclusion reached here is that these supposedly independent problems are, in fact, one and the same.

Drastic implications: virtual irrelevance of import controls to payments imbalance

This has drastic implications. The most important is that restrictions on international trade and financial flows are of little value in curing payments imbalance. They help only insofar as they improve tax revenues or increase domestic acquisition of public sector debt or, in other words, only because they affect fiscal and monetary variables. It would be more honest, and also less prone to cause distortions, to operate on these variable directly. There is an obvious message for the many Third World nations which, in response to balance-of-payments weakness, are now busy erecting tariff and non-tariff barriers to trade. But the point is equally relevant for advanced industrial countries. In Britain, the Cambridge Economic Policy Group has warned that the balance of payments is damned beyond redemption by adverse long-term import trends and that the only reliable method of countering these trends is import control. Although its prognosis has not so far proved correct, the Group's work has attracted much comment and seems to have encouraged the Labour Party to favour import restrictions. The ideas developed in this article suggest that, on the contrary, import restrictions would be almost useless as an antidote to international payments imbalance.

Key distinction between public and private sectors

To help organise the argument we start with the familiar flow-of-funds identity. It states that the foreign sector's financial position is the counterpart to that of the public and private sectors combined.

Overseas sector's net acquisition of financial assets (NAFA)
= public sector's NAFA + private sector's NAFA

When the overseas sector's net acquisition of financial assets is positive, a country is running a current account deficit. The conventional view is that a "problem" exists if the deficit is unsustainably large and must be corrected by policy action. We may break down the total current account deficit into two parts.

Current account deficit = public sector deficit + private sector deficit

This is not strictly accurate because the public or private sector might have a positive net acquisition of financial assets outweighed by a negative NAFA by the other, but it simplifies the discussion to assume that both sectors contribute - at least, in an arithmetical sense - to the current account deficit.

Does private sector indebtedness matter?

Let us suppose initially that the current account deficit is attributable to the private sector. The private sector is running into debt with the rest of the world. Why does this matter? Within an economy it is an everyday event for companies and individuals to borrow from one another. They do so with advantage because they have different time preferences, different production opportunities or different cash flow patterns. Equally, it is possible for the set of private companies and individuals which comprise one economy to incur debt to the set of private companies and individuals which comprise another economy. Although every agent is acting independently, in the aggregate the private sector agents in one country have a current account deficit. Since the numerous borrowing decisions responsible for the deficit are taken freely, it is unclear why the government should be concerned or why policy needs to be amended. Perhaps, as Corden has remarked, "One should ... just assume for the purposes of discussing balance-of-payments issues that the private sector knows what it is doing, and what is good for it, as far as its spending and savings decisions are concerned." (W. M. Corden *Inflation, Exchange Rates and the World Economy*, Oxford 1977, p.45. The aim of the present paper can be regarded as giving Corden's insight further elaboration.)

Capital flows motivated by different rates of return

In the past, many countries have registered persistent private sector current account deficits with no detriment to their economies. The characteristic explanation is that they have been able to cover the deficits by capital inflows, normally attracted by a better rate of return than in the source country. The consequent higher level of capital accumulation has accelerated the growth of output, including exports, and enabled the debts to be repaid without difficulty.

A classic illustration is provided by the USA in the nineteenth century. In the decade to 1878 its trade deficit averaged 0.8 per cent of net national product and the current account deficit, boosted by interest and dividend payments to foreign investors, was even larger. But in the early twentieth century it began to earn substantial trade surpluses and became a capital exporter. (G. E. Wood and D. R. Mudd 'The recent US trade deficit' *Federal Reserve Bank of St. Louis Review* April 1978, p.3.)

Can the private sector be misled by public sector actions?

But some economists might protest that these arguments are based on too sharp a differentiation between public and private sector decision-taking. What happens if a private sector current account deficit emerges because companies and individuals misinterpret macroeconomic signals given by unsound official policy? When these signals are shown to have been wrong and the private sector cannot repay, should not the blame be placed on the government? And does not this carry the implication that policy-makers should be worried about a private sector current account deficit and take remedial measures if they think it excessive?

These questions raise some potentially awkward issues. The most troublesome example is where a central bank keeps interest rates "too low", promoting heavy borrowing by the private sector and hence leading to a current account deficit. But it is necessary to remember that, unless they are prevented by official restrictions, private sector agents have discretion about the currency in which debts are denominated. Suppose that interest rates in, say, Brazil are "too low", that bank credit and so the money supply are expanding quickly and that the cruzeiro is under pressure. The probability of depreciation is known to private agents at home and abroad. Foreign lenders and Brazilian borrowers can intermediate in cruzeiros or, if they so wish, in dollars or another recognised convertible currency. The foreigners - aware that depreciation of claims expressed in cruzeiro terms is likely - will take this into account when drawing up debt contracts. If they have little trust in the Brazilian bank because it is setting "too low" interest rates, Brazilian individuals will be unable to borrow in cruzeiros from foreigners. It is a mistake to imagine that central banks can saddle residents of their country with huge foreign debts by tampering with interest rates in home currency terms.

But risks of assessing government policy are just another commercial risk

The plain fact is that risk attaches - and, in a market economy, is understood to attach - to every credit transaction between private agents. Part of this risk stems from the difficulty of forecasting macroeconomic trends. This element in risk is found in borrowing and lending between residents of the same country. The main new dimension in borrowing and lending between residents of different countries is exchange rate variation. But, just as a central bank is not responsible for compensating agents in its own country when they have been upset by an unexpected interest rate change, so it should not be responsible for compensating agents at home or abroad because of an unexpected exchange rate change. The Federal Reserve need be no more involved if a company in

Brazil defaults on a dollar loan than if a company in Massachusetts does so. By extension, why should a current account deficit between the private sectors of the USA and Brazil be of any more interest to it than a current account deficit between the private individuals of Massachusetts and California?

It is quite possible that, after international financial flows, private sector agents in both debtor and creditor countries find they have made mistakes. But, when one party to a credit transaction undertaken between nationals of one country defaults, there is no presumption that the government will automatically help the other party. It is therefore unclear why the government of one country should intervene if its citizens fail to honour their foreign debts. Apart from providing law courts to arbitrate on disputes, the state has no particular duty or obligation. To put the argument at its most polemical, there is not such thing as a balance-of-payments "problem" between consenting adults.

The government's position

The matter is quite different when we consider a current account deficit attributable to the government's behaviour. The deficit can be covered either by drawing down foreign currency reserves or by increasing external indebtedness. Reserve depletion is a finite process and must, at some stage, be reversed. There must also be some upper limit to the external indebtedness a government can tolerate, although the scope for debate about what that limit may be is considerable. Since both reserve depletion and foreign borrowing cannot continue for ever, a public sector current account deficit poses a genuine problem for policy-makers. They must sooner or later take action to solve it. But what action is needed?

The answer is contained by the identity:

> Public sector current account deficit = Public sector financial deficit - sales of public sector debt to the domestic private sector (including money creation)

Public sector payments can be reduced only by, i. cutting budget deficit, or ii. increasing domestic debt sales

This makes the obvious statement that the public sector's contribution to a current account deficit is equal to the total increase in its financial liabilities minus that part of the total increase taken up by domestic savings. It is also clear that the external deficit can be reduced in two ways - by reducing the public sector financial deficit (which, from now on, we shall call 'the budget deficit' for brevity) or by increasing domestic sales of public sector debt. Any policy measure which does not affect the budget deficit or the domestic demands for government debt is futile as a response to balance-of-payments difficulties; any measure which does affect these two variables also changes the public sector's current account deficit. As we have already argued that the private sector's current account is not a relevant concern for policy-makers, it follows that the solution to payments imbalance is to be sought only in fiscal or debt

management policy. This is a strong assertion. If it is accepted, much previous analysis of the balance of payments is superseded.

There is no doubt that economists have not in the past seen balance-of-payments problems exclusively in fiscal terms. In the next two sections we shall, therefore, consider the characteristic symptoms of payments imbalance in two recent periods, the fixed exchange rate regime before 1971 and the floating exchange rate regime subsequently, and relate these symptoms to fiscal and debt management policies.

Payments crises in the Bretton Woods era: the crucial role of changes in foreign exchange reserves

In the Bretton Woods system of fixed exchange rates one key pressure-gauge for assessing balance-of-payments difficulties was the movement in foreign currency reserves. Central banks were expected to sell foreign currency and buy their own if the exchange rate was in trouble. By using their ammunition of accumulated dollars they could fight back against speculative attacks on their currency; if the ammunition was exhausted they had to admit defeat and accept the ultimate disgrace of devaluation. According to Johnson, the balance-of-payments concept relevant to "policy properly defined and to the corresponding instruments of macroeconomic policy is the net inflow or outflow of international reserves". (See H. G. Johnson 'The monetary theory of imbalance-of-payments policies', pp.262-84, in J. A. Frenkel and H. G. Johnson (eds.) *The Monetary Approach to the Balance of Payments*, London 1976. The quotation is from p.262.) The theme can be dated back to his celebrated 1958 paper, 'Towards a general theory of the balance of payments', in which he stated that the "balance of payments relevant to economic analysis" was the difference between residents' receipts from and payments to foreigners, with a deficit being "financed by sales of domestic currency by residents or foreigners to the exchange authority in exchange for foreign currency".(H. G. Johnson 'Towards a general theory of the balance of payments', pp.153-68, in *International Trade and Economic Growth* (London; Allen & Unwin 1958), reprinted on pp.237-55 of R. N. Cooper (ed.) *International Finance* (Harmondsworth: Penguin 1969). The quotations are from p.239 of Cooper's collection.) Johnson clearly assumed the presence of an exchange authority, in the form of a central bank, acting as the principal intermediary between the citizens of one country and those of another.

Were changes in the reserves best seen in monetary or fiscal terms?

The need was to derive a theory which accounted for changes in the reserves. The monetary approach to the balance of payments was developed, notably by Johnson, in response to this need. It explained how the official settlements balance of payments was determined by the difference between the increase in the demand for money and domestic credit expansion. As such, it was "a monetary phenomenon, representing a disequilibrium in the demand for money". Johnson made strong claims for the monetary approach - for example, that it debunked much Keynesian analysis which had paid excessive attention to aggregate expenditure decisions as an influence on international payments.

But our formulation contains an alternative explanation of the official settlements balance. We make the assumption that the central bank has only two assets - claims on the domestic government and foreign currency reserves. In the 1950s and 1960s this would have been a realistic assumption in the overwhelming majority of countries. We also assume that the central bank is reluctant to expand its liabilities because additions to high-powered money may become the raw material for excessive growth of bank credit. In this case, if the government fails to borrow from the domestic private sector to cover its budget deficit, it must appeal to the central bank. The central bank can meet the demand only by selling foreign exchange - and any sales represent a deficit on official settlements. We seem to have turned Johnson's argument on its head Far from being a monetary phenomenon, the official settlements balance of payments can be interpreted in fiscal terms. The solution to unfavourable official settlements is to be sought in reductions in the budget deficit or more aggressive attempts to sell government debt to domestic entities other than the central bank.

Sterling crises were familiar sequel to fiscal reflation

By stating the problem in fiscal terms some fresh insights have been generated. We have identified the government as the most likely culprit for an unsustainable imbalance on official settlements. The sequence of sterling crises in Britain illustrated the point clearly. Following recommendations from its Keynesian advisers, the government from time to time embarked on fiscal reflation which involved a deliberate increase in the budget deficit. After a relatively short period, often no more than a year or eighteen months, there was a run on the reserves. The official reply was typically a "package" of public expenditure cuts, taxation increases and higher interest rates. The balance of payments then convalesced and the reserve position improved. A rise in unemployment followed, prompting another bout of fiscal reflation, another sterling crises and another "package". In Brittan's words, "Chancellors behaved like simple Pavlovian dogs responding to two main stimuli: one was 'a run on the reserves' and the other was '500,000 unemployed' - a figure which was later increased to above 600,000." (S. Brittan *Steering the Economy* (Harmondsworth: Penguin 1971), with the quotation from p.455.)

Payments crises since the move to floating exchange rates in 1971

The Bretton Woods regime of fixed exchange rates was effectively terminated by the USA's decision to suspend the convertibility of the dollar into gold in August 1971. Since then the major currencies have for most of the time been floating against each other. This has changed the form of the typical balance-of-payments crisis. In the 1950s and 1960s, when the reserves were both the first and last line of defence, a run on the reserves necessitated early action on the budget deficit or interest rates. Today the option of devaluation is also available. The environment for deficit countries has become more permissive in another respect. Large international capital markets with the capacity to lend to governments for balance-of-payments financing have developed, with OPEC members being an important source of funds after the oil price rise of 1973/74. Instead of having to appeal to the International

Monetary Fund, which imposed conditions to ensure a return to payments balance within a set timetable, deficit countries have been able to borrow from private commercial banks.

The new choices of devaluation and borrowing

The two new choices - devaluation and borrowing - have changed governments' perceptions about how they should meet payments difficulties. Particularly in the Third World, but also among many industrial countries attitudes have become more lax. Budget deficits represent a much higher proportion of national income in nearly all countries. Are the frequency of devaluation and the scale of borrowing for balance-of-payments purposes related to these large budget deficits and, if so, in what ways?

We stated earlier that the public sector current account deficit was equal to the budget deficit minus domestic debt sales. At first sight, devaluation is not much help in curing the deficit because it has no obvious repercussions on either the budgetary position or debt sales. However, this is too superficial a view. There are indirect relationships, working through the balance sheets of the central bank and the domestic commercial banks, between devaluation and a government's ability to finance its deficit internally.

Devaluation increases demand for monetary base

Devaluation is usually followed by a rise in the price level. The higher price level is accompanied by an increased demand for both the monetary base and money (i.e., an increased willingness to hold the liabilities of the central bank and the commercial banks). As a result the banking system can expand its assets without disturbing monetary equilibrium. The central bank, as banker to the government, is always under an obligation to take on more public sector debt. In an economy free from official regulations, the commercial banks might refuse to lend to government if they thought the loans would be unprofitable. But in most Third World countries the banks are either nationalised or subject to some degree of official arm-twisting. They also have to accept new public sector debt in their balance sheets. In other words, devaluation enables a government to increase its domestic debt sales. The higher price level associated with it causes the private sector to wish to hold more notes and coin, and more bank deposits. By holding more monetary assets economic agents are - through a slightly circuitous route - purchasing more government debt. Notes and coin are claims on the central bank, but the central bank matches them by claims on government; and deposits are liabilities of banks, but banks match them by investing in government paper.

and so facilitates levying of the inflation tax

Indeed, it is an open question whether devaluation should be regarded as a method of promoting domestic debt sales or as a way of levying the inflation tax. An econometric analysis of Italy's exchange rate movements in the 1970s concluded that, "the monetary financing of over one-third of the government's deficit effectively implied that ... nine-tenths of the increase in the total monetary base was accounted for by the Treasury, causing an expansion in high-powered money well in excess of that which would have been consistent

with a reasonable stability in the value of the lira." Its author judged that "the sharp increase in the monetary base plus inflation meant that the public paid a growing part of taxes in the form of the inflation tax on on their money balances. In the years 1972-75 the yield from this tax turned out to be almost equal to that from income tax." (R. Masera 'The interaction between money, the exchange rate and prices: the Italian experience in the 1970s, p.233-47, in A. S. Courakis (ed.) *Inflation, Depression and Economic Policy* in the West, London 1981. The quotations are from p.244.)

Borrowing may become preferable to devaluation and inflation

But Italy is only a mild example of the problems which can arise. In many Third World countries, particularly in Latin America, devaluation is almost synonymous with inflation. Consequently, it may seem preferable for a government with a large budget deficit to borrow abroad. No hard-and-fast criteria for deciding whether a government's external debt is excessive have been agreed. In principle, a government could be running a continuous current account deficit as long as the resulting growth of its foreign debt and servicing costs is no faster than the growth of its national income. The situation becomes unsustainable only when this condition is violated. In that case the government must sooner or later take measures to reduce its foreign borrowing. If no measures are taken, the government will finally be unable to pay interest and will have to seek rescheduling of its debt.

Balance-of-payments crises since 1971 have, therefore, been rather different dramas from those in the 1950s and 1960s. Whereas the main actors in the play used to be the government and the IMF, and the most absorbing item of stage scenery a change in the reserves, today international bankers have been added to the cast, and devaluation and debt service ratios to the props. But the responsibility for balance-of-payment problems still rests with governments and their budget deficits.

Direct restrictions futile as antidote to payments deficit, unless they,
i. reduce budget deficit, or
ii. increase domestic debt sales

Direct restrictions imposed for balance-of-payments reasons are of two main kinds - import controls and exchange controls. Are either of any value in solving a public sector current account deficit?

Import controls on private sector transactions are by themselves of little use. A public sector current account deficit if equal to the difference between two numbers - the public sector financial deficit and sales of public sector debt to the domestic private sector. Import controls can reduce it only insofar as they affect these variables. Tariffs yield revenue to the government and therefore lower the budget deficit. But, otherwise there are no obvious linkages at work. (In countries where collection costs of domestic taxes are high, "tariffs and export taxes may form part of a first-best tax package". (W. M. Corden *Trade Policy and Economic Welfare* Oxford 1974, p.66.) In fact, there are many developing countries where tariffs are introduced or raised explicitly for revenue-raising rather than protectionist purposes.) Some favourite Third

World responses to payments imbalance, such as quotas or placing luxuries on a list or prohibited imports, are futile, as public sector finances are unaffected. Aside from the boost to revenue from tariffs, import controls are pointless as an instrument for reducing the public sector's current account deficit. Nothing more needs to be said.

Exchange controls are more interesting. The most characteristic exchange control is a requirement that the private citizens of a country keep no foreign exchange in their own names and transfer any holdings to the central bank in return for domestic currency. Two observations may be made here.

Exchange control may increase holdings of public sector debtand serve as a form of taxation

First, exchange control may be viewed as serving the same function as devaluation. It increases the private sector's demand for government debt. When private sector agents are legally obliged to surrender foreign exchange to the central bank, they receive central bank liabilities in return (i.e. high-powered money in the form of notes or balances at the central bank). More frankly, they are forced to invest in the central bank. The central bank, as banker to the government, in turn invests in public sector debt. The private sector has indirectly financed the public sector deficit and may, to that extent, have reduced the public current account imbalance. Secondly, exchange control resembles inflation in that it is a form of taxation. Without exchange control private sector agents would not convert their foreign currency into domestic. It follows that, after compulsory conversion, there is excess supply of the domestic currency and its market-clearing price (in terms of foreign currency) is beneath the official price. The difference between the market-clearing and official exchange rates is an incentive for the creation of black markets. It is also a measure of the government's exchange control tax. As an instrument of taxation, exchange control enables governments to finance their foreign purchases at a lower price in domestic currency terms than would otherwise be the case. In this sense, it reduces the public sector financial deficit.

We have to concede that exchange controls, if they are effective, may cut the public sector's current account deficit. But they do so through means - taxation and increasing domestic demand for public sector debt - which have always been available to governments in more transparent forms. Exchange controls have no merits compared to the conventional techniques and they suffer from several obvious disadvantages. Not least among these disadvantages is the contempt for government aroused by the arbitrary character of the exchange control tax.

The central message

In summary, the message of the new approach to the balance of payments is that only foreign debts incurred by the public sector constitute a balance-of-payments problem and that the only solution is the pursuit of more appropriate fiscal and debt management policies. A further implication is that a country whose government has adopted responsible budgetary policies cannot have

external payments difficulties. The new approach provides reinforcement for the "old-time religion" of sound finance and balanced budgets.

Fiscal policy remains the key to the payments situation

If bankers want to avoid some of the sovereign debt difficulties they are now facing, they should in future focus on fiscal variables to assess a government's ability to repay. The abundance of a country's natural resources is of limited value unless they can be translated into tax revenue. Assertions such as "Mexico has oil" and "Argentina's agricultural potential is so great its finances can always be turned round" have been heard to justify the large loans extended to these two nations over the last decade. But Mexico's oil and Argentina's agricultural potential are not by themselves any help to foreign bankers holding claims on their governments. Bankers need dollars, not oil or beef. The only way, apart from borrowing, that the Mexican and Argentine governments can obtain dollars is by purchasing them with local currency; and the only way, apart from printing, that these governments can acquire surplus local currency is by having an excess of tax receipts over expenditure. If there is no prospect of a Third World government reorganising its public sector finances after a foreign borrowing programme, it is unwise for banks to participate in that programme while it is under way.

Cambridge advocacy of import controls refuted

Although reschedulings of Third World debt are the most topical application of the new approach to the balance of payments, it is also relevant to recent policy debates in the developed countries. It shows, for example, that the Cambridge Economic Policy Group's advocacy of import controls as an answer to future payments imbalance in Britain is misguided and unsound. There is a balance-of-payments problem only if the government has a financial deficit which it cannot cover by domestic debt sales. Paradoxically, a reliable method of creating such a problem would be fiscal reflation of the kind proposed in the 'alternative economic strategy' and supported by the CEPG. A further irony might be mentioned. There is a resemblance between our approach to the balance of payments and the New Cambridge School theory of the mid-1970s. The gravamen of this theory, also developed by the CEPG, was that the government's budget deficit - and only the government's budget deficit - was responsible for payments imbalance. Cambridge economists seem not to have recognised that this conclusion is inconsistent with their subsequent enthusiasm for import controls. Tariffs on finished manufactures would mitigate the problem to the extent that they boosted tax revenue, but otherwise they would be quite pointless.

If the government wants to avoid external constraints on economic policy, it should ensure that budgetary policy remains responsible. As long as the public sector borrowing requirement is a low and declining proportion of national income, Britain will not suffer from a balance-of-payments problem.