The Economic Environment:
Teaching Exchange Rates and Balance of Payments in the Context of the Eurozone Crisis

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Abstract

It is easy to teach international economics' topics simply from the point of view of the national economy, and lapse into a mercantilist approach which naively treats current account surpluses as 'good', per se, and deficits as 'bad'. While trade and current account balances clearly represent a zero-sum outcome, this is easy to overlook in teaching. Persistent imbalance is the problem, not deficits or surpluses per se.

A useful approach is to take a global perspective, focusing on the tradable sectors of national economies under conditions of both full employment and substantial unemployment. This presentation looks at the advantages and disadvantages of floating and fixed exchange rate systems, with a single-currency multiple-country system as a special case of the latter.

The Eurozone crisis serves as an ideal classroom example that is slowly unfolding in real-time, but that leads to much confusion in the media, and seemingly amongst many policy analysts. This is an intra-European trade crisis that is embedded in a wider global crisis of chronic fiscal and monetary imbalances.

The presentation finishes by showing how – with the help of clear yet uncomplicated thinking – these imbalances can resolve themselves within a federated fiscal and monetary union. New Zealand's close neighbour, Australia, is an excellent example of a union forged over 100 years ago from a group of countries that once faced similar challenges to those of the Eurozone today.

Introduction

First-year tertiary students learn three types of economics whose core assumptions are substantially exclusive. Our courses morph between the three with little awareness by teachers, let alone students.

These may be called: neoclassical, Keynesian and mercantilism. Conceptually more useful, they can be called: full-employment economics; unemployment (or recession) economics; zero-sum economics.

The distinction between full-employment and unemployment economics has been argued significantly by Paul Krugman and Richard Koo, although their boundaries differ. Koo distinguishes between normal recessions and balance-sheet recessions, noting that Japan experienced balance-sheet recession conditions throughout the 1990s and in the early 2000s. Koo also notes that the Great Depression of the 1930s as a balance-sheet recession, and regards the post-2008 condition of the developed industrialised economies likewise.

One of the most important distinctions between full-employment and unemployment economics is in the role of saving. In full-employment economics, saving is the requirement – forced through inflation, or voluntary – for capital accumulation which is the prerequisite for economic growth. In recession economics, the motivation for individuals to save (or repay debt) is strong, but the collective consequences of increased saving are calamitous.

Thus full-employment economics describes a win-win process, unemployment economics represents a lose-lose process. The third economics – mercantilism, or zero-sum economics – is conceptually a win-lose economics, although (as in some card games, such as Hearts), what is commonly seen as a winning hand has the potential to become its opposite, creating, as in depression economics, lose-lose or even lose-win outcomes.

This presentation discusses how teaching and learning in international topics drifts from win-win to win-lose economics. We see this bipolarity most strongly in our unsuredness as to whether an appreciation of a country's exchange rate is a good or bad thing for that country.

The consequence of our lack of clarity in teaching introductory economics is that those who have had some exposure to the subject – and indeed many who have had substantial exposure to the subject – see economic competition in win-lose terms, and see trading partners essentially as rivals. This perception is reinforced by the fact that in the real-world of business competition (imperfect competition to economists), reality takes over from the idealism that underpins full-employment economics.

Mercantilism

Mercantilism is a kind of guilty secret in economics. Classical and later neoclassical economics emerged as a reaction to what Adam Smith described as the "mercantile system" of business thought and government policy that prevailed in early modern Europe (15th to 18th centuries) and was fully compatible with attitudes to wealth that prevailed within East Asia. (Smith reserved some of his most trenchant criticism for the austere merchants of Holland and Hamburg.)

For those economics' students who study the history of their discipline, the mercantilist era is quickly brushed aside as the equivalent of economic alchemy. The remainder of economics' students rarely hear the term. Nevertheless, an entry of the word ‘mercantilism’ in Google will give a substantial number of hits, many of which do not relate to the period before the industrial revolution. The word is indeed a significant portal into the underworld of economic thought.

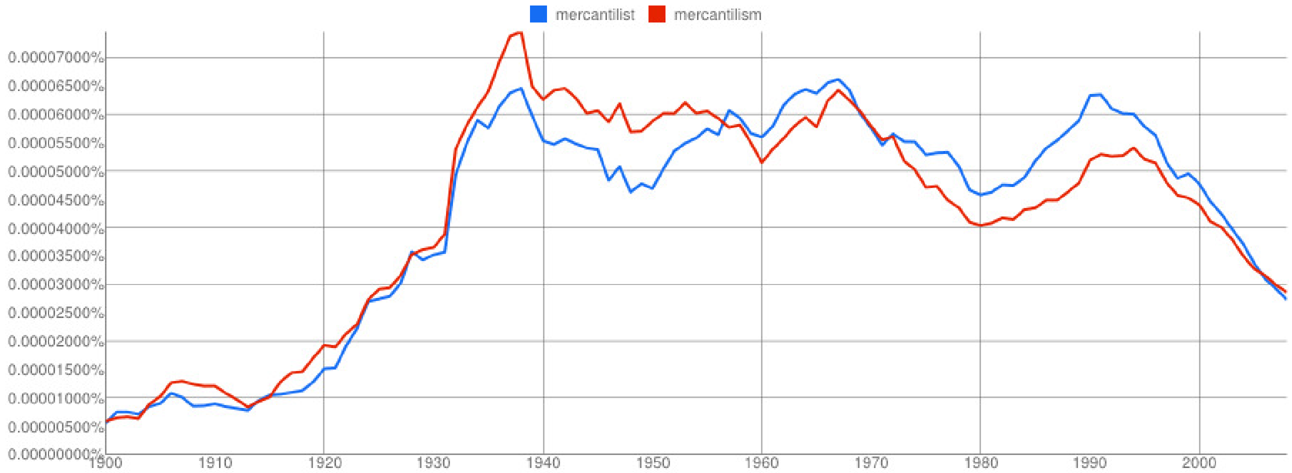
The central tenet of mercantilism was that national economic policy should be focussed on the accumulation of whatever passes for internationally acceptable money. Thus the obsession in the 16th and 17th centuries was to accumulate gold and silver in nations' Treasuries.

In practice, in the present as in the past, mercantilism is the pursuit of persistent and indefinite trade surpluses as national economic policy. It appears in any economics text that claims, explicitly or implicitly, that current account surpluses are good and that current account deficits are bad. It is related to the more general (though commonly believed) fallacies that lending is good (a winning activity) but borrowing is bad (a losing activity), and that selling is good but buying is bad. Mercantilism places the producer, not the consumer at the centre of the economic universe. Mercantilists are hoarders rather than circulators of money.

Mercantilist economics is zero-sum economics; because global trade balances (and current account balances) equal zero. Thus if any polity is to succeed in achieving persistent trade surpluses, then other nations by definition must be accumulating trade deficits. And the interest earned by such creditor countries must be re-invested into the deficit economies, ensuring ongoing current account imbalances even greater than the persistent trade imbalances.

Indeed the Great Depression of the early 1930s can only be properly understood in terms of the mercantilist trade policies, with their austerity/deflationary bias (Kindleberger, Eichengreen and DeLong), pursued generally in the 1920s as a lose-lose ‘race-to-the-bottom’. Figure 1 shows the increased awareness of the mercantilism fallacy in the years following the Great Depression. It also shows the reduced awareness of the concept since 1990, in the years when history has been de-emphasised in the teaching of economics.

Figure 1: Analysis from Google NGRAM



Teaching International Trade at Level 5

We start in full neoclassical mode, clearly explaining the gains of trade as necessarily being shared by both countries in a two-country trading relationship, and extending the idea to multilateral trade. For each country, the gains of trade are what each country ends up with. Thus the benefits of trade for a country are its imports, and the costs of trade are a country's exports. This is unambiguous. The resources incurred in producing an excess of a product for which that country has a comparative advantage are greater than the resources that would be required to produce what the people of that country would rather have. When each country exports such excesses in return for what they would rather have, then each country gains; it's a win-win outcome, and total consumable output is greater than if such trade did not take place. Further, trade always balances. Implicitly, in this model, it would be nonsense for a country to export something (incurring a cost) yet happily receive nothing in return.

Unbalanced trade makes sense however if we incorporate the concept of inter-temporal trade (trade over time) (Corden 2011). Thus a country might export more now (run a trade surplus) in exchange for even more imports later. Another country of course would have to do the reverse; import more now and incur an extra export cost later. The former country becomes a creditor; the latter a debtor. This arrangement would be tidy and easy for students to understand if such contracts have a specific and enforced maturity date; a date when a creditor country's contracted imports (with interest) are delivered to it.

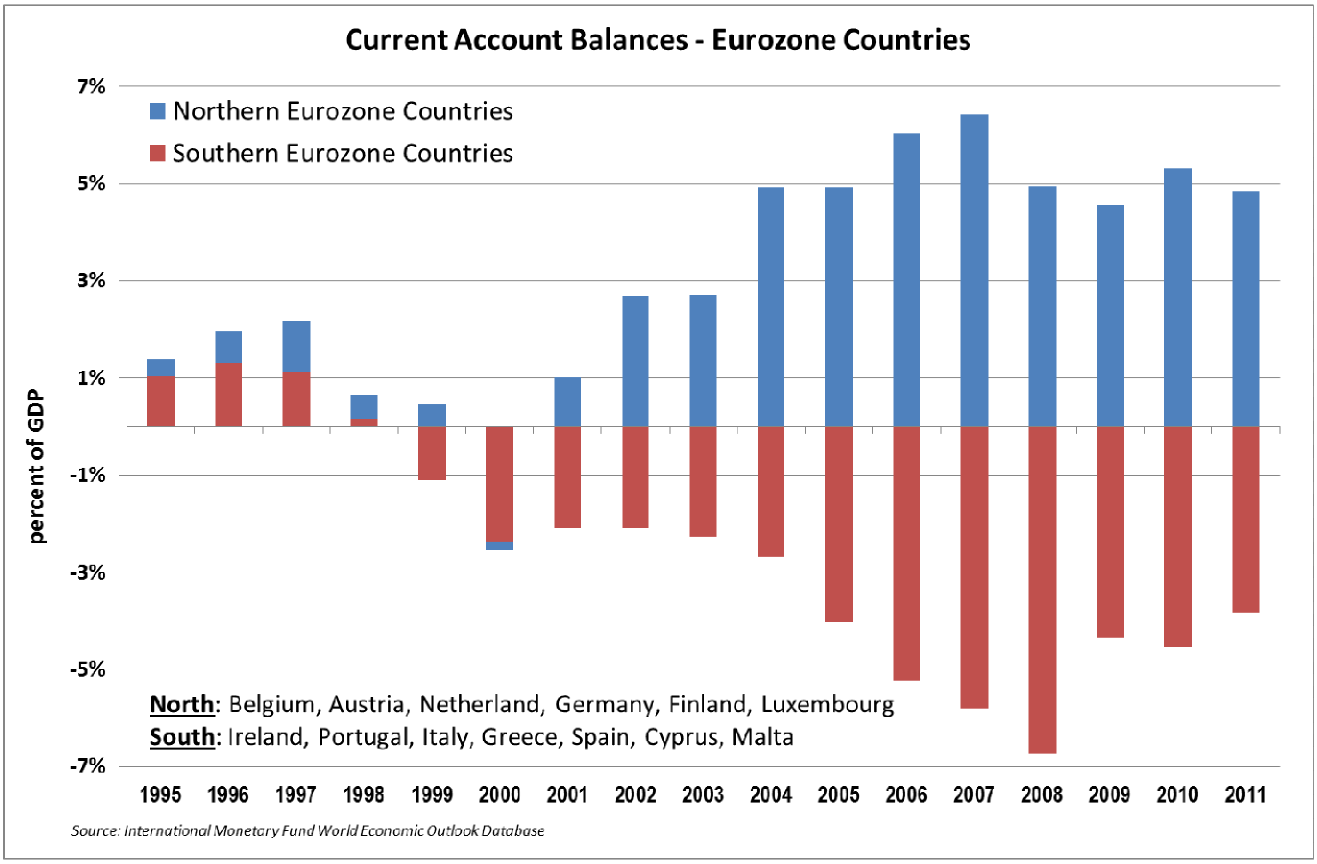
Real-World Trade

Real-world trade, however, is not like this. Most countries have either persistent current account surpluses or persistent deficits. We even call the former countries 'surplus countries', rather than using the more correct term 'creditor countries'. Thus lay people and economics' graduates alike find it hard to even conceive of these 'surplus' countries correcting their past trade imbalances as our trade theory says they must; namely by running trade deficits at least, or, preferably, current account deficits.

In a mercantilist world, countries are surplus-oriented and deficit-resistant. This seems a fair reflection of the widespread surplus-good deficit-bad outlook that many economic commentators and policy-makers hold; tempered however by the fact that, from the 1980s, low inflation has taken over (at least in the West) as the primary focus of monetary and (to a lesser extent) fiscal policy.

The Eurozone crisis, which in its essence is an exemplar case-study of unbalanced trade, gives an ideal opportunity to investigate this problem. Figure 2 shows the current account imbalances within the Eurozone of the European Union, before and after the creation of the Eurozone in 1999. (The only significant Eurozone country missing is France, which is not easily typecast as 'north' or 'south'.)

Figure 2



The pattern is very clear; the northern group of countries experienced persistent current account surpluses in the 2000s, and the southern countries experienced almost exactly matching deficits. We may also note that the southern countries did not experience such deficits in the half-decade before the formation of the Eurozone. This reflects a huge net north-south flow of credit within the Eurozone.

The Eurozone-wide solution to this problem is very clear, at least on paper. Trade within the Eurozone should be rebalanced. The northern creditor countries need to take their gains in the form of trade deficits, and the southern debtor countries must pay up, by running trade surpluses.

This however is not as easy in practice as in theory, and this reflects a simple lack of understanding of trade theory; a misunderstanding that led to major oversights when the Euro currency was created. It also most likely reflects a substantial undercurrent of mercantilism in northern European policy-making.

Indeed we cannot easily conceive of a country such as Germany choosing to run a decade of trade deficits in order to rebalance the Eurozone. While southern Europeans may drive Volkswagens, northern Europeans don't drive Fiats!

Exchange Rate systems

This leads us to the problem of our frequent failure to properly teach exchange rate *systems*. (To do this well, we need to pay much more than lip-service to economic history.) What we see is both balance of payments and exchange rates commonly taught from a nationalist (and possibly mercantilist) perspective rather than from a global perspective.

Since 1950, fully in the life-times of some if not most of our economics' teachers, the global economy has experienced both the fixed-exchange rate system (1950s, 1960s) and the floating system. The Euro experiment can be understood as an extreme form of the fixed system embedded within a wider floating system; new territory indeed!

The system of fixed exchange rates crashed three times last century; in the 1910s, the 1930s and the 1970s. Further, it did not work as it was meant to, even in its 19th century heyday. This was a period of massive global financial flows, not a period in which trade surplus countries experienced inflation to offset deflation in deficit countries.

The floating system conspicuously failed to conform to its principles in the 2000s. Surplus countries such as Japan experienced currency depreciations, whereas deficit countries such as New Zealand and Australia experienced substantial appreciations. (Koo [2009] devoted much of a chapter to the financial relationship between Japan and New Zealand.)

Further, we have heard much in recent years about "currency wars" (The Economist, Rickards), in which countries are depreciating their currencies in order to increase their trade surpluses or decrease their deficits. From a consumer's point of view – the view of full-employment economics – productivity increases lead to gains that are passed on to consumers via appreciating currencies. From a mercantilist producer-oriented view, currency depreciations lead to raised trade balances and less unemployment.

The Eurozone unbalanced trade crisis represents a regional systemic crisis within a wider global crisis of the floating exchange rate system and growing private-sector surpluses. (Increased global private-sector surpluses necessarily mean increased global public sector deficits; but that's another story.)

The regional crisis is one in which even the option of devaluation by government decree is not available. (The most famous of these in our life-times was the nearly 15% devaluation of the British Pound in 1967; a devaluation against the US dollar – and hence against gold – that New Zealand copied.) The problem as it now stands is that firms in the northern European Eurozone economies (especially the BANG countries: Belgium, Austria, Netherlands and Germany) are experiencing the mercantilist joys of an undervalued currency, whereas firms in the southern European Eurozone economies (especially the PIIGS countries: Portugal, Italy, Ireland, Greece, Spain) are experiencing the competitive hardships of an over-valued currency.

From Figure 2, an obvious remedy (that is, obvious to a well-taught economics' student; though far from simple in practice, given individuals' preference to hold a strong currency) presents itself. Split the Euro into two floating currencies; a southern Euro that should depreciate and a northern Euro that should appreciate. (A second practical problem – that identified by Koo – is that persistent current account deficit countries such as New Zealand have had appreciating rather than depreciating currencies.)

In this context, and with an understanding of the 1920s' experiences of these countries under the gold standard, we see a push for "austerity" on the southern countries; a push that would have been clearly understood as an attempt to create deflation, the alternative route to a "real" depreciation of a currency. Even this policy mix is unbalanced. For austerity to work in theory, an equivalent real appreciation of the Euro in the creditor north is required. The commitment to inflation in the north has to be as strong as a commitment to price and wage deflation in the south. Further, the whole exercise breeches the 'law of one price' that should hold within a free-exchange zone.

Precedent

Before 1901, New Zealand was a part of a precedent-of-sorts to the Eurozone crisis. New Zealand was one of seven Australasian countries that shared the same currency, the British pound. The analogy is quite close in the 1890s, when British finance was less readily available to fund current account deficits. These countries, together, gained a "get out of austerity free" card through refrigeration and other opportunities to develop primary export industries. But, at the time, the immediate solution proved to be labour mobility, especially labour flows from the countries without growth or credit inflows to the countries with growth. (Some countries, especially Victoria, also adopted substantial protectionist measures; an option not allowed within the European Union.) The longer-term solution was political union, with the formation of the Commonwealth of Australia reducing a set of extra-national imbalances to a set of inter-provincial imbalances (contrast Greece with East Germany) that could be smoothed out by a common regime of taxation and federal expenditure. (New Zealand stayed out largely because, in 1901, it was productively the strongest of the seven countries, and could see little advantage in joining.)

This case study of our own can help students to understand the economic significance of political union as a solution to structural trade imbalances between neighbouring countries.

Conclusion

Economics teaching of international topics commonly drifts from a quite precise treatment of balanced trade in a world under neoclassical full-employment fixed endowment assumptions, to a more nationalist treatment of balance of payments and exchange rate issues. Further, the implicit assumptions of what constitutes national welfare veer towards those of mercantilism, in which a country exporting more than it is importing is seen as doing well ('winning') whereas a country enjoying a greater inflow of goods and services than it is required to give up as exports is seen as performing badly ('losing').

The Eurozone crisis presents us with an opportunity to delve into these issues in a more systematic way. Trade imbalances may build up for a long time. Unsolved, when creditors refuse to use (spend) their credits, they stand to lose them in a regional or global systemic crisis.

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