What a floating currency gives and what it does not

By Martin Wolf

The UK has monetary and fiscal policy autonomy but had little adjustment in the current account

The crisis has brought important lessons about the benefits of possessing a freely floating currency. One benefit, UK experience suggests, is monetary and fiscal policy autonomy. But a substantial depreciation has contributed much less to the adjustment of the current account than most would have expected. These lessons have important policy implications.

As Belgian economist Paul De Grauwe of the London School of Economics has noted, the benefits of retaining a currency on one’s own are visible in the post-crisis interest rates paid on long-term public debt. The observation is simple: the International Monetary Fund’s forecasts for the ratio of net public debt to gross domestic product of the UK and Spain are essentially identical. In 2017, the ratio is 93 per cent for the UK and 95 per cent for Spain. Yet the yield on UK 10-year bonds is firmly under 2 per cent – among the lowest in UK history, and not much above Germany’s. The yield on Spanish 10-year bonds, meanwhile, is just under 5 per cent, far below the 7.5 per cent last July, but expensive for a country that is being forced towards deflation.

Why should countries with such similar fiscal positions face such different bond yields? One possible explanation is the UK’s long history of successful debt management. Also relevant is the fact that Spanish bonds may still be thought subject to the catastrophic risk of a eurozone break-up, despite the European Central Bank’s promise to intervene via its programme of outright monetary transactions. The ability and desire of the Bank of England to prevent outright default is more credible than that of an independent, supranational central bank. The BoE, as buyer of last resort, also promises market liquidity. If the market for public debt is subject to self-fulfilling prophecies of good or bad outcomes, this should guarantee stability at favourable rates.

Being a monetary area, as the UK is with sterling, offers further benefits. One is that it is its own haven for people who need to hold assets in the domestic currency. The haven in the eurozone, however, is Germany. In times of panic, money tends to flee there from weaker member countries, causing fiscal and financial crises. Second, if people wish to hold fewer sterling-denominated liabilities, the exchange rate provides a mechanism for adjustment. For Spain, however, the adjustment is through the yield.

What is clear is that becoming part of a currency union undermines a government’s ability to manage public debt. This has important spillover effects on to banks and so credit supply. The UK also has problems, but they are less severe and more susceptible to policy.

Yet the impact of the devaluation of sterling – roughly 20 per cent on a trade-weighted basis since late 2007 – has been disappointing, a point discussed last February by Martin Weale, a member of the BoE’s Monetary Policy Committee, and in the latest BoE Inflation Report. The most recent IMF forecasts provide a simple story: in 2007, the UK had a current account deficit of 2.3 per cent of GDP, against 10 per cent in Spain, 10.1 per cent in Portugal and 14.6 per cent in Greece. But, in 2012, the UK’s deficit is forecast to be up to 3.5 per cent of GDP, against 1.1 per cent in Spain, 1.5 per cent in Portugal and 2.9 per cent in Greece.

Furthermore, the volume of UK exports grew between the second quarter of 2009 and the third quarter of 2012 by less than those from troubled eurozone countries. Part of the reason these countries’ exports have done better than the UK’s is that their recessions have been far deeper. But France, Germany and the US have also done better.

After a long period when its share in the imports of goods of other members of the Group of Seven countries was in decline, the UK’s share has stabilised since the crisis. This is not enough. Part of the reason performance has disappointed is that its fall in productivity growth has partly offset the devaluation.
Meanwhile, the UK’s share of the G7’s services imports, which was soaring before the crisis, stabilised and then fell. A leading element in the poor performance is declining exports of financial services. So the financial crisis has hit the UK via its exports. It came to rely on a sector that produces a service the world wants less. I cannot blame the world. But, adds the BoE, reduced supply may also affect these exports.

The failure to achieve a big adjustment in the current account is deeply troubling. This is true, above all, because such adjustment is the only way to combine a desire to eliminate the fiscal deficit with the likelihood of continued frugality in the UK private sector. If the current account does not adjust, either the fiscal consolidation will not happen or, if it does, it will be at the expense of a prolonged slump in output. The flexible exchange rate has given the UK autonomy. That is good. But it has not given it adjustment. This is bad. Indeed, it is a big disappointment.

martin.wolf@ft.com

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