"Recent balance of payments experience suggests that in advanced open economies, liberalised capital movements and floating exchange rates have abolished the 'external constraint'". Compare macroeconomic policy towards the current account under fixed exchange rates with capital controls (as under Bretton Woods) with the current international financial system. Is the balance of payments a matter for private sector indebtedness only? Can government ignore the balance of payments?

The past century has seen the implementation of different exchange rate mechanisms in the face of radically changing political and economic situations. We have seen a shift from the gold standard before 1914, to the free flat period (1919-1926), Ephemeral gold standard (1927-1931), and the managed float (1931-1939) during the interwar years. This was followed by the Bretton Woods system, and after its collapse in the early 1970s, most of the major currencies were floating against each other. Since then different countries have used different mechanisms including free floating exchange rates, multiple exchange rates, managed exchange rate flexibility, and a variety of hard pegs (such as monetary unions, dollarization, and currency boards.) In this essay, we will initially compare macroeconomic policy toward the current account under Bretton Woods with some of the current mechanisms. We will then discuss the validity of the statement in the title and assess the importance of balance of payments for the economic well being of a country.

The agreement at Bretton Woods in 1944 re-established fixed (but adjustable) exchange rates between currencies in the form of so-called 'par values', defined in terms of gold. Countries were obliged to intervene in the market to maintain the exchange rate within 1% either side of its par value without permission of the IMF and by more than 10% if it was convinced that the balance of payments of the country concerned was in fundamental disequilibrium. In theory balance-of-payments adjustment under a gold exchange system is supposed to work in the same way as under the gold standard, with deficit countries allowing prices to fall and interest rates to rise (by reducing their dollar reserve, i.e. contraction of money supply), whilst surplus countries allow prices to rise and interest rates to fall (by expanding the money supply). This helps to achieve external equilibrium; however, this does not guarantee internal balance in the sense of full employment unless there is an appropriate reduction in real wages in the case of the deficit country. In the Articles of Agreement of the Bretton Woods system, however, it was clearly recognised that internal price flexibility could not be relied on and that if provisions were not made it would be income and employment that suffer most from the adjustment, as in the inter-war years. Two provisions were made to safeguard full employment. First, a country in temporary disequilibrium (cyclical) could borrow from the IMF to tide it over its difficulties without having to pursue internal adjustment policies, which threatened employment. Second, provision was made for exchange-rate adjustment in cases of fundamental disequilibrium – which was rarely used in reality.

Under freely floating exchange rates, the exchange rate is left to find its own level in the market without any official intervention. Balance-of-payments equilibrium is supposed to be achieved automatically, but only in a net currency flow sense. In an economic system in which the authorities are indifferent to the exchange arte, there is no need for international reserves. In practice, however, countries are not indifferent to the value of their currency in relation to others, and in the recent past free floating had never been adopted for any length of time as an exchange-rate regime.

Under managed floating there are no pegs and no parities that the authorities are obliged to preserve. Instead the currency is free to float but the authorities intervene to avoid what they regard to be undesirable consequences of excessive appreciation or depreciation. An example of managed exchange rated would be setting target zones for exchange rate movements but with 'soft bands' – as opposed to rigid bands under pegged rates. To operate a managed float requires that the monetary authorities add to the supplyu of or demand for foreign exchange as circumstances warrant in order to achieve the exchange rate desired. The limits to which a country can manage a floating rate depends on the volume of reserves it has (to defend a depreciating currency), and its ability to control the money supply, if need be, as it accumulated reserves (to prevent an appreciating currency). Countries may also experience international pressure to let the market operate freely, particularly surplus countries that accumulate reserves instead of allowing the exchange rate to appreciate. Williamson (1983) has emphasised the need for a greater degree of exchange rate management if the misalignments of the early 1980s are to be avoided in the future. In particular, he has stressed the need for target zones which, he defines as being closer to a form of floating exchange rates than to an adjustable peg system. 'Target zones have "soft margins" which the authorities are *not* committed to defending'. Williamson suggests that monetary policy is the best policy instrument to use in order to manage the exchange rate within its bands. This is because changes in the rate of interest have a quick and easily predictable effect on the exchange rate.

Recently a number of countries have adopted 'hard peg' exchange rate regimes. These differ from the soft pegs by the fact that they do not allow margins of fluctuations and that they rule out realignments (devaluations and revaluations). Hume's mechanism has made a comeback by eliminating discretionary monetary policy entirely and reducing central banks to the role of passive bureaux de change. Three varieties of hard pegs have been observed which are worth noting.

A monetary union involves the irrevocable fixing of exchange rates and the abandonment of margins of fluctuation among a number of countries. In fact it means that individual currencies are no longer distinguishable, a common currency may be substituted. The immediate implication is that individual central banks lose any remaining autonomy, although one central bank is needed to manage the common currency. The union's central bank manages the overall money supply. Interest rates are the same across the union since money can flow freely. National money supplies are then determined through the Hume mechanism. If a country runs a balance of payments surplus, money is flowing in and the national money supply rises; a deficit results in loss of money supply. Although it might seem strange for independent countries to give up their currencies, it is, in fact, the logical consequence of the impossible trinity: with full capital mobility, fixed

exchange rates imply the loss of monetary policy autonomy. Yet, the threat of currency crises remains: the only was to eliminate that threat is to eliminate the currencies themselves. Since there is no real policy autonomy to lose, the system can only be strengthened. At the same time, however, there are costs of a monetary union: giving up monetary or exchange rate policy has its own consequences. In the end it depends on the company a country chooses. A region constitutes an optimum currency area when its use of a common currency implies no loss of welfare, where the likelihood of problematic asymmetric shocks (since exchange rate can no longer be used, the adjustment must take place through prices) are reduced by factor mobility, and either, production of very similar or, very diverse products across the union. The wave of capital account liberalization, when combined with the attachment of some countries to exchange rate stability, makes it attractive to move from a soft peg to a hard peg, hence the renewed appeal of monetary unions.

Dollarization is the unilateral adoption by a country of a US dollar as sole legal tender, which can be thought of as a one-sided monetary union with the United States. It is as close to the gold standard as a monetary system can be, without having gold itself to circulate; it functions in the same was, including Hume's mechanism. A number of countries never had their own currency: Panama and Liberia have been dollarized since their independence. Ecuador and El Salvador adopted the dollar in 2000 and 2001 respectively. One reason for dollarizing is the perception that a foreign central bank will do a better job at enforcing price stability than an indigenous one. Another reason is proven inability to come to grips with inflation, as in the case of Ecuador. If trade links with the country whose currency is adopted are intensive, it seems like a good idea. It remains, however, that the international rate is driven by foreign economic conditions, which may be awkward.

Currency Boards used to be the arrangement of choice in the British Empire. They have made a comeback, starting with Hong Kong in 1983, followed by Argentina in 1991 (which led to a devastating default in 2002), Estonia in 1992, Lithuania in 1994, Bulgaria and Bosnia-Herzegovina in 1997. Currency boards resemble dollarization, except that the local currency is maintained. A fixed exchange rate is established vis-à-vis an anchor currency. The local currency is fully convertible into the anchor currency at that rate, with no limit. The local currency is fully backed by reserves. This is required to ensure full and unlimited convertibility. Currency boards often hold reserves of 105% or 110% of their liabilities, a precaution since most of money is produced by commercial banks which are not restricted to 100% backing. In practice, it means that the high-powered money supply is entirely driven by the balance of payments via Hume's mechanism. Monetary authorities are completely passive. With the exception of Hong Kong, currency boards have usually been adopted by countries which have long suffered high inflation and felt that there was no political will to establish a full-blown independent central bank dedicated to price stability. Estonia (a transition country) started off with a currency board, and its success at avoiding inflation has inspired many others.

As it can be seen, the current international financial situation has tended towards liberalised capital movement and floating exchange rates (in some countries).

The experience of the major economies over the last twenty five years has led to a divide amongst economists as to the importance of the balance of payments in determining

output and growth. The concept of equilibrium balance of payments growth rates gives some theoretical insight into the problem, showing that under certain assumptions, unless a current account deficit can be financed, economic growth is 'constrained' by the balance of payments. This immediately poses a number of questions; for example, can the deficits of economies such as the UK and US be maintained indefinitely without any cost to the economy? If so, one could possibly argue that a constraint no longer exists. We shall now turn to exploring these issues further, drawing in particular on evidence form the UK.

Thilwall constructs a model to demonstrate the role of international trade in determining economic growth. First, suppose the balance of payments is in initial current disequilibrium summarised as follows:

$$P_d X + F = P_f M E$$

In the above equation X is the volume of exports, P_d is the domestic price of exports, M is the volume of imports, P_f is the foreign price of imports, E is the exchange rate and F is the value of nominal capital flows measured in domestic currency. If F is positive there is a net capital inflow and if negative, a capital outflow. Let us also define a variable θ, where θ and $(1- \theta)$ represent the shares of exports and capital flows as a proportion of total receipts – to what extend imports are paid for through exports and capital flows. In order to derive the rate of growth of output, various assumptions must be made. First we assume multiplicative import and export demand functions. The second assumption is that relative prices measured in a common currency remain unchanged over the long run (from the law of one price). Finally, we assume that the rate of growth of the volume of exports is equal to the product of the income elasticity of demand for exports and the rate of growth of world income. If π is the income elasticity of demand for imports, we obtain the equation:

$$y_B^* = \frac{\theta x + (1-\theta)(f - p_d)}{\pi}$$

The above result