**BALANCE-OF-PAYMENTS THEORY
AND THE UNITED KINGDOM EXPERIENCE**

A.P. Thirlwall,
*Balance-of-Payments Theory and
the United Kingdom Experience*

Other books by the author

*Growth and Development: with Special Reference to Developing
Economies*, Second Edition

Inflation, Saving and Growth in Developing Economies

Financing Economic Development

Regional Growth and Unemployment in the United Kingdom
(with R. Dixon)

Keynes and International Monetary Relations (editor)

Keynes and Laissez-Faire (editor)

Keynes and the Bloomsbury Group (editor with D. Crabtree)

Keynes as a Policy Adviser (editor)

Balance-of-Payments Theory and the United Kingdom Experience

SECOND EDITION

A. P. THIRLWALL

*Professor of Applied Economics
University of Kent at Canterbury*

M

© A. P. Thirlwall 1980, 1982

All rights reserved. No part of this publication
may be reproduced or transmitted, in any form
or by any means, without permission.

First edition 1980

Second edition 1982

Published by

THE MACMILLAN PRESS LTD

London and Basingstoke

*Companies and representatives
throughout the world*

ISBN 978-0-333-34307-4

DOI 10.1007/978-1-349-06534-9

ISBN 978-1-349-06534-9 (eBook)

Typeset in Great Britain by

REPRODUCTION DRAWINGS LTD

Sutton, Surrey

The paperback edition of this book is sold subject to the condition that it shall not, by way of trade or otherwise, be lent, re-sold, hired out, or otherwise circulated without the publisher's prior consent in any form of binding or cover other than that in which it is published and without a similar condition including this condition being imposed on the subsequent purchaser.

To Merlyn Rees, M.P.,
who first taught me to think and write

Contents

<i>Preface to the First Edition</i>	xi
<i>Preface to the Second Edition</i>	xiv
<i>Acknowledgements</i>	xv
1 Balance-of-Payments Accounting and the Foreign-Exchange Market	1
Concepts of the balance of payments	1
The accounting balance of payments	2
Balance-of-payments equilibrium	5
More on the concept of equilibrium	19
The foreign-exchange market	22
The demand for dollars	23
The supply of dollars	26
Capital movements and speculation	31
The forward rate of exchange	33
Types of exchange-rate regime	37
Fixed versus flexible exchange rates	43
2 The Balance of Payments and the National Economy	48
The integration of the balance of payments into the national accounts	48
The conflict between balance-of-payments equilibrium and other objectives of economic policy	50
Income equilibrium in an open economy and the foreign-trade multiplier	54
The foreign-trade multiplier relating imports to expenditure	57
The 'new' foreign-trade multiplier with foreign repercussions	61

Balance-of-payments adjustment	65
The classical price-specie flow mechanism	66
The elasticity approach	67
The absorption approach	69
The monetary approach	69
3 The Elasticity Approach to the Balance of Payments	72
The Marshall–Lerner condition derived	72
Devaluation and the response of firms	78
Lags and the <i>J</i> -curve effect	83
Devaluation and inflation	85
Devaluation and the terms of trade	92
The difficulties of measuring price elasticities	93
4 The Absorption Approach to the Balance of Payments	98
The direct effect of devaluation on income	100
The direct effect of devaluation on absorption	101
The interaction between changes in income and changes in absorption	103
Strengths and dangers of the absorption approach	105
The monetary aspects of balance-of-payments deficits	107
Domestic credit expansion	108
5 The Monetary Approach to the Balance of Payments	110
6 Simultaneous Internal and External Balance	118
Internal and external balance under flexible exchange rates with no capital movements	120
Internal and external balance under fixed exchange rates with capital movements	124

Internal and external balance in an <i>IS-LM</i> curve framework	129
The use of monetary and fiscal policy under alternative exchange-rate regimes	131
The assignment of policies in the United Kingdom	132
 7 A History of the U.K. Balance of Payments	 134
1854 to 1939	134
1940 to 1950	140
1951 to 1959	143
1960 to 1969	148
Devaluation, 1967	154
1970 to 1980	157
Appendix 7.1: an economic analysis of the United Kingdom's payments difficulties in the 1960s – the prelude to devaluation, 1967	166
Appendix 7.2: a polemic on floating the pound, 1972	181
 8 Import Functions	 194
The determinants of imports	194
Imports and capacity	196
Imports and labour-market bottlenecks	200
Imports and income (estimates of income elasticities)	204
Imports and relative prices (estimates of price elasticities)	210
Import penetration	212
 9 Export Functions	 221
The determinants of exports	221
Exports and capacity	222
Exports and world income (estimates of income elasticities)	229
Exports and relative prices (estimates of price elasticities)	230
The United Kingdom's declining share of world exports	238
Appendix: commodity and geographic composition of U.K. exports and imports	244

10 The Balance-of-Payments Equilibrium Growth Rate	250
The determination of the balance-of-payments equilibrium growth rate	251
A fundamental law of growth	254
11 Export-led Growth	259
The importance of export-led growth	259
Models of export-led growth	263
An export-led growth model with a balance-of-payments constraint	269
12 The Balance of Payments as a Structural Problem	273
Non-price factors determining exports and imports	276
North Sea oil and the balance of payments	280
The balance of payments and de-industrialisation	283
Import controls	286
<i>Notes</i>	288
<i>References</i>	297
<i>Name Index</i>	309
<i>Subject Index</i>	312

Preface to the First Edition

This book has two main purposes: first, to provide an elementary exposition of the balance of payments and of balance-of-payments adjustment theory; and second, to challenge the relevance of conventional adjustment mechanisms as solutions to the United Kingdom's weak balance of payments.

Even before I started to do my own research and thinking about the balance of payments I was sceptical of the view that countries' balance-of-payments problems are primarily a function of adverse relative price movements which can be rectified by adjustments to the exchange rate. Where the scepticism originates I am not sure but it has spilt over into dissatisfaction with most of the textbooks on the balance of payments, and with their treatment of balance-of-payments adjustment theory, which more or less take for granted, with various degrees of qualification, that relative price adjustments through a change in the exchange rate will secure for a country simultaneous internal and external equilibrium. This was the driving intellectual force in fashion when the world moved to floating exchange rates in 1973.

My scepticism has been most acute in the case of the United Kingdom, which has experienced persistent difficulty in reconciling balance-of-payments equilibrium with full employment and a higher growth rate, and where, as it turns out, devaluation and currency depreciation have been singularly unsuccessful in reconciling the conflict.

My dissatisfaction is not confined to traditional neoclassical price-adjustment theory. It extends to the more recent monetary approach to the balance of payments which gives the impression, whether it intends to or not, that all balance-of-payments difficulties have their origin in monetary disequilibrium and that monetary correction is a sufficient condition for internal and external balance.

It is argued strongly in the book, particularly in Chapters 10 and 11, that the balance of payments must be viewed in a growth context, and that at the heart of the United Kingdom's economic difficulties is the slow rate of growth of exports, which cannot be raised permanently, if at all, by exchange-rate depreciation, and is not amenable to monetary manipulation. The problem requires real economic policies of a structural nature related to the wider characteristics of goods, such as their quality, design and reliability, marketing and delivery. Exchange-rate depreciation simply ossifies the industrial structure and makes manufacturers temporarily more competitive in the export of goods with given characteristics which were the source of the payments weakness in the first place. As I argue in Chapter 10, I am convinced in my own mind that the United Kingdom's inferior economic record in relation to other industrialised countries, particularly since 1950, is largely a function of its balance-of-payments strait-jacket caused by the slow rate of growth of exports relative to other countries, and until this underlying weakness is rectified the United Kingdom will be condemned to a low growth rate and the spectre of rising unemployment whatever other domestic policies are pursued.

Apart from being an unusual (but I hope appealing and convincing) mixture of textbook and polemic, the book has two other features which distinguish it from traditional texts. First, it is argued strongly that the focus of balance-of-payments policy ought to be on the current account. To focus elsewhere, as the new monetary approach to the balance of payments urges, can store up trouble for countries in the future by delaying the real economic adjustments that a country must make ultimately. Second, for the first time in a textbook, the foreign-trade multiplier is presented relating imports to expenditure - this is obviously more realistic than relating imports to income if the import coefficients of various components of domestic expenditure differ.

Finally, an attempt has been made to organise the book in such a way that it can be used both as a preliminary text on balance-of-payments theory and also as a source of reference on the performance of the U.K. balance of payments which can be updated in subsequent editions if the book proves useful to students.

In writing the book I am in debt to a number of organisations and individuals. The Social Science Research Council financed my research on labour-market bottlenecks and the balance of payments. During the project several other ideas were developed. The Treasury and the

Department of Trade and Industry provided me with statistics. Mr John Goy and Mrs Julia Stevens of the University of Kent Library obtained and checked references for me. The editors of *Banca Nazionale del Lavoro Quarterly Review*, *Applied Economics*, the *Oxford Bulletin of Economics and Statistics* and the *National Westminster Bank Quarterly Review* gave me permission to reproduce certain material which first appeared in their journals. Mrs June Harrison typed the manuscript with superb efficiency. Finally, my colleagues Richard Disney, John Craven, Charles Kennedy, Bob Dixon and Thea Sinclair, helped to improve the book with their constructive comments on various chapters. To all these I am deeply grateful, but they bear no responsibility for the deficiencies which remain.

1980

A. P. T.

Preface to the Second Edition

This revised edition, two years after the book's initial publication, is designed to bring up to date all the tables relating to the balance of payments, imports and exports, the commodity and geographic composition of trade, the exchange rate, and so on, and also the text relating to the history of the United Kingdom balance of payments. The tables and text now extend to the year 1980. The new edition also gives me the opportunity to correct some minor printing errors that occurred on initial publication.

For teaching purposes, the format of the book remains exactly the same. As far as the central thesis of the book is concerned, nothing has changed to alter my conviction that the United Kingdom's industrial weakness requires a positive and aggressive foreign trade strategy. If anything, the relentless growth of import penetration and the loss of jobs in manufacturing strengthen that conviction.

I am very grateful to my secretary, Hilary Daly, for help in preparing the manuscript for press.

1982

A.P.T.

Acknowledgements

The author and publishers wish to thank the following, who have kindly given permission for the use of copyright material:

Basil Blackwell Publisher Ltd, for a table from *Oxford Bulletin of Economics and Statistics* (November 1977); Cambridge University Press, for tables from *Abstracts of British Historical Statistics*, by Mitchell and Deane; The Controller of Her Majesty's Stationery Office, for tables from *U.K. Balance of Payments, Key Statistics*, and *Economic Progress Reports*; Lloyds Bank Ltd, for a table from *Lloyds Bank Review* (January 1975), by M. Panić; National and Commercial Banking Group Ltd, for a table from 'Floating Rates - Expectations and Experience', by Fred Hirsch and David Higham, reproduced in *Three Banks Review* (June 1974); National Westminster Bank Ltd, for a table based on figures from *National Westminster Bank Quarterly Review* (May 1975); Organization for Economic Co-operation and Development, for a table derived from *OECD Manpower and Labour Force Statistics*; Martin Robertson & Company, for an extract from *Modern Capitalism: Its Growth and Transformation*, by J. Cornwall (1977).