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ARTICLES

EEC Membership

Impact on British Balance of Payments

by Professor Paul Streeten, Brighton *

The likely effects on the balance of payments in the event of Britain's joining the Common Market must be analysed in two stages. First, assuming present exchange rates, what is likely to be the impact of Britain's joining on its balance of payments? This is the problem of transition, though transitional adjustment may take a long time. Second, what will be the enduring problems after transitional adjustments have been made?

The Transitional Period

There can be little doubt that Britain's balance of payments is likely to deteriorate compared with what it would otherwise have been, though whether the deficit will be increased or the surplus reduced will depend upon the success of the November 1967 devaluation of Sterling. There are six reasons for this:

□ The cost of food imports will be higher. It has been estimated that the cost of food will rise by 10 to 14 per cent and therefore the cost of living by $2\frac{1}{2}$ to $3\frac{1}{2}$ per cent. If wholesalers and retailers maintain percentage margins, the rise would be greater.

□ Import levies will have to be imposed on food bought outside the Common Market and these levies would have to be paid back to the Common Market. Official estimates put the cost of these two items at £175 mn to £250 mn per year.

□ The rise in the cost of living is likely to push up wages and other money incomes and this is likely to reduce exports. A $2\frac{1}{2}$ - $3\frac{1}{2}$ p.c. rise in living costs might lead to a $1\frac{1}{2}$ - $2\frac{1}{2}$ per cent rise in money wages and a 1-2 per cent rise in export prices. Dr Beckerman estimated the rise to be $2\frac{1}{2}$ per cent. On the other hand, even in the transitional period, competition may raise productivity, lower costs and therefore not push up export prices or not push them up

by so much. The net outcome is very difficult to assess.

□ The loss of preferences in the Commonwealth and of free entry to EFTA countries which would not join would further reduce exports. At present exports to the Commonwealth are £900 mn p.a., 50 per cent of which enters duty-free. The loss under items 3 and 4 may be another £200 mn p.a.

□ Imports of manufactured goods into Britain would rise, partly as a result of higher domestic costs and prices and partly because of tariff reductions. This may amount to £75 mn p.a. It is true that the reduction of the external tariff of the Common Market resulting from the Kennedy Round reduces the extra imports due to elimination of the lower tariff. But it also reduces the extra exports which we can sell to the wider, now less protected, market.

□ Finally, there is the effect on capital account. The dismantling of exchange controls on capital movements may amount to a loss of at least another £100 mn. Against this, there may be additional capital inflow from America. But it is very difficult to assess the balance of considerations. While foreign investment in Britain becomes more attractive because an English-speaking base can supply the European market, some EFTA markets would become less attractive, and the removal of the British tariff makes it possible to reach the British market from a plant on the Continent. It is by no means clear that, on balance, Britain would gain capital.

More problematical are additional costs to the balance of payments which would arise from the adoption of a tax on value added and of harmonisation of social insurance contributions levied on employers of labour. The former might raise the cost of living and industrial costs by 2-4 per cent and add another £200 mn to the balance of payments loss.

The total balance of payments costs might therefore be in the neighbourhood of £500 mn p.a. Pessimists

* I am indebted to Clive Bell for valuable help in the preparation of this article. Material from my book *Economic Integration* (Sythoff, Leiden) has been used and brought up to date and I acknowledge the permission of my publisher to do this.

put it much higher, to around £1,000 mn, while optimists say that even £500 mn is an overestimate.¹

The devaluation of sterling in November 1967 will, of course, improve the British balance of payments. But this improvement is already mortgaged to repayment of debts, strengthening of reserves and perhaps aid and overseas investment outside Europe. The balance of payments losses inflicted would be over and above these claims.

Tom Lehrer's dope pedlar is doing well by doing good. Britain would be in the reverse position of doing badly by doing wrong.

Long-term Adjustments

Whatever the problems of transition, they would have to be tackled somehow—by a further alignment of exchange rates or by using article 108 to deal with balance of payments difficulties, or by massive deflation. And the transitional solution is bound to affect the long-term solution. But in this section we turn to the balance of payments problems that arise after this transitional adjustment has been made.

The questions that have to be asked are these: Will Europe as a whole be more or less vulnerable to balance of payments crises with the rest of the world? Will any one European country be more or less vulnerable to balance of payments crises with other European countries? Which deficits should be corrected and which financed? For those which should be corrected, what medicines will be available for cure? Will the use of a given dose of these medicines be more or less effective than before integration?

Europe's Balance of Trade Will Deteriorate

Although it can be shown that for a given level of income Europe's terms of trade with the rest of the world are bound to improve, since the eagerness to trade with the rest of the world must decline, the effect on the balance of trade is uncertain. Let us assume first income and output constant in order to

¹ Mr Douglas Jay suggests £1,000 mn, Dr Beckerman £800 mn on current account only, and The Times (1st May 1967) between £500 and £800 mn.

focus attention on the price effects. It is true that European countries will buy more from each other and less from the rest of the world, and imports into Europe will therefore decline. But it is also true that European countries will sell more to each other and less will therefore be exported to the rest of the world. The effect on the balance of payments of Europe with the rest of the world is thus uncertain. If intra-European demand and supply elasticities are sufficiently high, while demand elasticities for imports from outside are low, European exports may be greatly reduced without a large reduction in imports, and Europe's balance of trade will deteriorate. The correction of the imbalance will have secondary effects on the terms of trade.

But income and production will not stay put. If they increase, and if we assume relative prices constant, more will be imported from outside Europe. But equally, more is available for exports. How much more will be imported depends on the income elasticity of demand for imports, while the increase in exports depends on the output elasticity of supply of exports, i.e. the increase in the desire to sell exports at constant prices, as a result of an increase in production. Hence again, the net effect is uncertain, though on plausible assumptions the balance will tend to deteriorate.

Within Europe, different countries will be affected differently, according to the initial height of the tariffs and the degree of quantitative restrictions, and their demand and supply elasticities. But, other things being equal, the larger volume of intra-European trade will make countries more vulnerable to balance of payments crises in their trade with each other, unless liquid reserves or credits are increased sufficiently.

Methods of Correcting Disequilibrium

Temporary deficits should be financed, persistent deficits should be corrected. The trouble lies, partly, in telling which is which. But even if the two aspects could be separated, fluctuations round an equilibrium trend may be too large for the available finance, and even an underlying trend away from equilibrium could, in some conditions, be properly financed. It

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may be that the high rate of increase in money wages or the low rate of growth of saving could be corrected, after a time, by a sufficiently high rate of investment. If this investment can be financed by foreign loans, the disequilibrium will eventually be corrected. But equally it may be that the financing simply postpones the necessary internal measures, or worse, aggravates the disequilibrium.

While fluctuations of trade will tend to be greater with larger trade, the methods of correcting them will have been curtailed. Foreign exchange controls and import restrictions, tariffs and possibly even devaluation will have been ruled out. We shall discuss below the merits of the various remaining methods of correcting and financing deficits, but while the disease (fluctuations in the balance of payments) is likely to get worse, the medicine cupboard will be emptier.

One might argue that a given dose of the remaining medicines, whether devaluation or deflation, will be more potent, since demand and supply will be more responsive to any given price movement. The removal of foreign exchange and quota restrictions (the imposition of which reduces elasticities to zero) will clearly raise price elasticities. It may be that stronger competition, fuller information, a wider market, and a wider range of substitutes, also contribute to this end. On the other hand, it is equally possible that a greater number of differentiated products and oligopolistic competition reduce demand elasticities, and thus make adjustments in response to given price changes more difficult.

It is clear that if the chief economic objectives of integration are to be achieved, investment in plant and equipment for the large European market must be encouraged to take place on the optimum scale, and in the right directions. This in turn requires that businessmen must be reasonably confident that trade will not be cut off as soon as countries run into balance of payments difficulties.

In the following, the possible approaches to a solution of intra-European payments may be discussed.

The Instrument of Import Restrictions ...

The reimposition of import restrictions, unless strictly temporary, would frustrate the purpose of the whole exercise of integration.² It would reduce the expansion of desirable investment which depends upon a reliable market. Permanent import controls are ruled out by the Treaty and by GATT.

A stronger case can be made out for purely temporary restrictions, limited in time to say, three or six months. Ideally, foreign exchange reserves are inadequate and credits not available, temporary restrictions have much to commend them.

The wisdom and efficacy of import restrictions have been strongly criticised. Just as in the 'forties doubts

about the efficacy of devaluation in correcting a balance of payments deficit were widely expressed, so in the 'fifties and 'sixties a new pessimism was voiced about all methods attempting directly to tackle the balance of payments in conditions of full employment or inflation.

The first point to note about the doctrine of the impotence of import restrictions is that even if valid, it applies only to restrictions imposed for global balance of payments reasons, but not to those imposed to correct imbalances with certain countries. The efficacy of restrictions intended to divert trade from some countries to others remains unaffected, even if it were true that restrictions intended to reduce total imports were futile.

Nor does it follow that import restrictions are useless; they are particularly valuable for discrimination and for correcting a temporary deficit. There are a number of ways in which import restrictions can directly raise domestic savings and reduce domestic investment, thus contributing to the restoration of balance, without any additional deflationary measures.

... A Contribution to Restore the Balance

☐ Individuals and firms may allow their cash balances to rise as certain goods cease to be available, without running down any other assets.

☐ Individuals and firms may use up stocks as imports are reduced. There is good evidence for the strong correlation between changes in the balance of payments and changes in stockbuilding. If a national balance sheet were drawn up and stocks were added to international reserves as liquid assets, the liquidity position would appear much more stable than if, as is customary, only the latter are shown. For example, there is some evidence that the sluggishness of adjustment of the UK balance of payments following devaluation in 1967 is partly due to an upswing in the stock-building cycle. The rise in cash balances represents an induced increase in savings and the running down of stocks an induced reduction in investment, both of which will give at least short-term relief to the balance.

☐ The propensity to consume is itself a function of the availability of certain imported goods. It is stimulated by the import of foreign goods and can be damped down by their absence.

☐ When prices rise as a result of the diversion of import demand to domestic substitutes, income is redistributed towards profits and away from fixed income receivers. This shift is likely to raise the average propensity to save.

☐ Even with existing tax rates, a rise in domestic prices and money income will raise tax receipts and thus public savings.

☐ If prices are administered and extra demand is reflected in lengthening order books, priority can be given to export orders. This means that domestic in-

² This is reflected in the strong opposition by its Common Market partners to the import quotas recently imposed by France.

vestment will be reduced (if they are investment goods) and domestic savings increased.

The identity that the excess of investment over savings equals the excess of imports over exports is, of course, true only in conditions of strictly full employment. In practice, however, full employment conditions are not sharply defined and there is normally some spare capacity. It is, of course, likely that the fuller use of labour and capital resources will lead to price rises long before strictly full production has been reached. Control of the prices of imports and domestic substitutes could be used to present a cost-of-living and wage inflation.

We may conclude that the prevalent pessimism with respect to the efficacy of import controls is unjustified, particularly if they were to be used as short-term measures. There need not be inflationary consequences and, even if there are, these can, if accompanied by other appropriate measures, carry the cure with them. It could even be argued that the holding of stocks has certain advantages over the holding of liquid international reserves as a second line of defence, since they yield a return.

But it is notoriously difficult to distinguish between temporary and persistent causes of disturbances, and import restrictions would be incapable of contributing, by themselves, very much to the solution of these dynamic disequilibria, indeed they might aggravate them.

Credits as Temporary Measure Only

The provision of finance for bridging over deficits, like import restrictions, is more suitable as a temporary measure than as a fundamental correction, although we have seen that finance, again like import restrictions, may contribute towards fundamental adjustments.

Its chief purpose would be to supplement inadequate international liquid reserves.³ One could envisage a variety of institutional arrangements. The system may be automatic, like that under the European Payments Union. Or countries may supply their own currencies and gold and dollars and acquire drawing rights, like a European Monetary Fund. Or these currencies may be paid into a European pool which is used as a cash basis by a European Central Bank, which has discretionary powers to make advances, discount bills and operate in the open market. The currencies surrendered to this pool could be related to each country's own reserves, or they could, ultimately, comprise the whole of the European national reserves.

A European Central Bank, with power to grant credits beyond the surpluses accumulated by creditor countries on their accounts with the Bank, would certainly contribute to an expansionist solution, but it would not be sufficient. First, countries may not want to

³ The long series of credits advanced to the UK by various national and international banks provides a recent example.

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run into debt beyond a certain point, and the problem of how to prevent restrictions or deflation would remain. Secondly, if there are no restraints on borrowing, a country is free to inflate indefinitely, letting its deficits be financed by less inflationary countries through the European Bank. The question is partly whether internal checks to inflation and deflation are sufficiently strong to exempt the European Bank of exercising control over these matters. Alternatively, the Bank would have to be allowed to exert pressures on borrowers, as well as to give guarantees to lenders. Creditors would get guarantees against inconvertibility, exchange depreciation and default. Debtors would have to undertake to surrender all foreign exchange balances to the Central Bank, to keep their currencies convertible and not to devalue.

Devaluation: Enemy of Integration

Repeated devaluations or floating exchange rates are often thought to combine the virtues of fundamental international corrections, of full employment and free trade. Professor Meade has argued that, although not ideal, they are the least evil method.⁴ Yet, not unlike import restrictions, exchange rate variations suffer from the defect that they frustrate the purposes of

⁴ J. E. Meade, "The Balance-of-Payments Problem of a European Free-Trade-Area", *The Economic Journal*, September 1957.

European integration. Being able to sell at some price—though a reduced one (from the point of view of the seller)—may be less harmful to long-term investment decisions than being completely cut off, but the fear that customers may devalue must have discouraging effects on the type of investment that would be needed. Forward exchange dealings may insure the trader against exchange risks, but they clearly add to his costs, and do nothing to insure long-term lenders against exchange risks. Yet, free capital movements are essential for the success of integration. If called upon to say what better alternative there is, I would suggest intra-European short-term and long-term credits not just as palliatives, but as means of attaining balances in international payments. They could make the same contribution towards more permanent equilibrium that free capital movements and governmental expenditure make in an integrated national market.

Common Currency and Full Integration

Full monetary integration would mean that the intra-European settlements are made on the same basis as intra-regional settlements within one country. A European Central Bank in which all foreign exchange reserves would be pooled and which would grant credits on this cash base, is only one condition of such full integration. There would also have to be a European fiscal authority, whose tax receipts would decline as money income in one country fell while its expenditure to the country would be maintained (family allowances, subsidies, grants, etc.) or increased (unemployment pay, public works programmes, government contracts), so that the balance of payments on government account would tend to compensate for the deterioration on trading account.

A unified European capital market with a European Stock Exchange would lead to compensating movements on private capital account. As investment exceeds attempted savings in the deficit country, its holders of securities will sell some of their securities. These will be bought by the members of surplus countries whose attempted savings exceed their in-

vestment. A substantial divergence of yield of similar securities for any length of time will be impossible.

If the European government pursues full employment and development area policies, and takes active steps to promote labour mobility, further equilibrating forces will be introduced. Finally, a common policy towards the rest of the world would mean that, if one European country had a deficit with another, while the other European country had a greater deficit with the rest of the world, so that Europe were in deficit with the outside, the correction of the deficit with the outside would tend to increase purchases from and reduce sales to the first country.

In view of these common policies, less would be left to be done by the purely monetary mechanism.

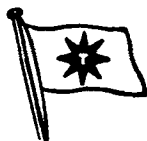
Proposal: A More Complementary Trade Area

It is now possible to lay down two conditions which European integration has to meet in order to promote the ideals implicit in the notion of integration.

First, there must be a method of correcting balance of payments deficits which does not impose unemployment or cuts in production. This may be done by a system of intra-European credits, some kind of European bank money, or by the transformation of surpluses into development loans.

Second, European integration would be better founded if more than a handful and preferably all overseas countries producing primary products but attempting development could be brought in, so that a large, potentially more complementary trading area were created. Europe by itself lacks the cheap food and raw materials necessary to feed itself economically and keep its industry going.

Both, however, assume a special importance in Britain's case: the first because the experience of attempted correction of the balance of payments by deflation is not likely to be forgotten; and the second because it would go a long way to meet the historical, political and moral as well as the balance of payments problems posed by the existence of the Commonwealth.



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