Trade deficits: An MMT perspective

Student Research Internship Report

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Trade deficit – MMT perspective

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Modern Monetary Theory (MMT) is a heterodox branch of economics which states that any kind of financial constraint doesn't matter whether in terms of fiscal deficit or trade deficit for a monetary sovereign nation. It is only "real constraint" that is vital.

Trade deficit – Modern Monetary Theory

Trade balance is the difference between nation's export and import. A negative trade balance (trade deficit) is real benefit to a nation, as export is a "real" cost incurred to a nation because it uses its productivity capacity to fulfill other countries demand, on the other hand, import is "real" benefit enjoyed by a nation because importing nation gets to use goods and services that are produced by foreigners.

Foreigners incurs the cost or deprive their own citizen to use those goods to export it because they desire to hold assets in the deficit nation in order to earn higher returns. Therefore, it is the demand for a nation's goods or asset claim by foreigners that drives the demand for a particular nation's currency. In this way by being in deficit (net import) a nation finance foreigner's desire to hold net financial claim on itself. "It "pays for" those net imports through expansion of its capital account surplus. On the capital account, this is reflected in rest of world accumulation of financial claims denominated in the importer's currency" (Wary, 2014). However, deficit countries are to convert those liabilities into real capital and return on that real capital is expected to be greater than the cost of borrowing.

Changed notion

Fixed exchange rate regime that was prevalent till 1970s in which countries used to peg their currency against gold/US dollar (Bretton Woods system). So, if a person comes with the currency, then the government was obliged to convert it to either gold/US dollar at the fixed rate. A nation with trade deficit faced a huge dilemma under this system. Since, they

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had to pay for import in gold and under Bretton wood system during trade deficit USD were used to buy the excess supply of importing nation currency from foreign exchange market, to keep the exchange rate fixed – both (Gold and USD) were limited in amount with a nation. Therefore, in order to keep reserves from exhausting, countries were forced to opt for internal devaluation by rising interest rate, wage cuts, inducing domestic demand to fall which in turn lead to unemployment and stagnant growth so that import falls. Raised rate of interest also attract investment restoring reserves. 'Even when high interest rates succeeded in protecting gold reserves, the policy often had devastating consequences' (Kelton, 2020). Ultimately Bretton wood system (fixed exchange rate regime) collapsed in 1971. And world moved to flexible exchange rate regime under which exchange rate were determined by demand and supply of currency. With the changing system, prospects and stand of trade also changed. No longer the expansionary fiscal policy was counter by monetary policy intervention for the check on exchange rate. Government is free to solve the domestic problem. Trade deficit is no way a problem as long as the country's currencies is in demand. Adjustment in exchange rate take cares of trade deficit – as the import grows more than export, supply of importing nation's currency increases more than its demand due to which currency loose its value that make import expensive hence, reducing it and makes export attractive for foreigners.

For a monetary sovereign nation which issue its own currency, tax in own currency, practice flexible exchange regime and issue debt mostly in own currency has enough policy space so that external sector constraint doesn't matter. Countries such as USA, Japan, UK, Australia fit in this criterion of MMT countries.

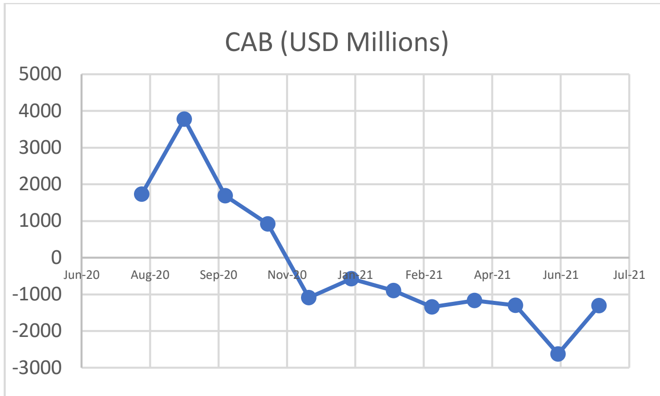
However, developing countries cannot have persistent trade deficit even if it issues non – convertible currency and float its currency. Generally, it has to pay for import in USD which can only be printed by United States. They become a currency user (has to earn before it spends), making a country partially monetary sovereign only (Kaboub, 2019). Situation gets worse for a developing country which is dependent on rest of the world for essential stuff – food, energy etc. This is a "real" constraint for an economy. It can't reduce its import. Currency starts depreciating, it becomes less desirable by foreigner so, they pull out. Since, monetary policy is weak instrument to stimulate growth, especially in crisis –

no rise in interest rate brings confidence of investors back, instead there will be fewer domestic investment as cost of borrowing goes up. Countries end up taking loan denominated in foreign currency and to service the debt again a loan. This is a balance of payment crisis (inability to pay for imports and service external debt). And if a country prints money to pay off those debt it increases the money supply in economy without adding to productivity which further adds to already existing inflation that is being imported and gets a nation into hyperinflation. IMF/World Bank comes in along with their "tight fiscal and monetary policy measures" in bail-out packages providing patch solution, leading to misallocation of already scares resource of developing countries, they never focus on root cause of problem. Typically guiding economies to indulge in activity which brings foreign reserves – like promoting tourism, producing cash crops instead of cereals. Hence, telling the economy to live with those "real constraints".

Consequences of "typical" solution: -

Southeast Asian countries which are heavily dependent on tourism for economic growth, are hit by pandemic. Thai Baht has performed worst, demand for Baht is falling as tourism is set backed, it depreciated 10% (Tan, 2021) against USD making import expensive. Foreign investors pull out a net $3.34 billion from Thailand's stocks, weighing further on the currency (Yuvejwattana, 2021). Economy is witnessing first current account deficit after 2013 as tourism collapsed (Figure 1). The tourism sector, accounts for about a fifth of GDP and 20 percent of employment (Kaendera & Leigh, 2021). Since, April 2020, 2 million workers in the tourism sector are laid off. Thailand's GDP fell by 6.1 percent in 2020, the largest contraction since the Asian financial crisis 1997 (Kaendera & Leigh, 2021).

Figure 1. Thailand Current account



Source: (Trading Economics, 2021)

This could further tear the expectations of investors and foreign reserves starts to deplete. This is a result of high dependence on external sector to pay for import – a problem recognized by MMT In fact, tourism is a "real" cost for an economy, tourist consumes domestic food, energy (Kaboub, 2019). Now, how the Thai economy responds to the upcoming challenge is yet to be discovered!

Table 1. Developing countries trade breakup: -

Countries	Major exports (2019)	Major imports (2019)
Venezuela	88.7% Minerals, Oil	16.8% Refined petroleum
		18.5% Cereals + foodstuff
		16% Machines
Ghana	50% Precious metals	17% Transportation
	25% Minerals, oils	14.5% Machines
	12% Cocoa	
Jordan	33.04% Chemical Products	16.8% Refined petroleum and gas
	21% Cloths	13% Machines and electronics
		10% Vehicles
Zimbabwe	51% Precious metals	27.9% Refined petroleum
	15.2% Tobacco	16.13% Machines and appliances

Source: (Observatory of Economic Complexity , 2021)

These economies (Table 1) indulge in exporting low-value added inputs having low-income elasticity and imports high-value added output, which keeps them in trade deficit, under the burden of external debt. They are just one shock away from collapsing!

MMT's Solution

MMT recognizes that trade policy can't be generalized for all countries around the globe and there exists a monetary sovereignty spectrum among nation.

As in the word of Stephanie Kelton:

"*The problem is that there isn't a robust, permanent appetite for developing countries' financial assets or real estate. Economists say that they lack deep capital markets. While investors will speculate in emerging markets, buying financial assets denominated in a developing country's local currency, they don't make the kinds of long-term investments that would allow developing countries to gain durable access to currencies like the US dollar."* (Kelton, 2020)

Developing Countries require specific solution to their problem focusing on long term growth. Government spending helps in such situation by creating productive capacity within the nation, replacing import of 'basic good'. "Here lies the importance of the transfer of resources to poor countries to maintain their momentum of development (global Keynesianism)" (Thirlwall, 2011). Attracting FDI which adds to output growth and productivity play an important role in this process. Developing countries has to indulge in creating a diversified economy. Taking the case of China – it provided giant MNCs with its cheap labor and gave the market access, with a pre-condition to share the technical 'know-how' with domestic players. This allowed China to build domestic capacity.

In fact, trade deficit is a healthy sign for developing nation as in developing phase when they largely import capital, machines etc. which are essential for capacity building. It signifies that domestic demand is growing and country is seen as a good investment hub by rest of the world. 'Developing countries has to work on being self-sufficient in renewable energy source, agricultural advancement otherwise they will always be dependent on rest of the world for fossil fuels' (Kaboub, 2019). If an economy is able to installs productive capacity, it automatically becomes a booming market. It is a simple link - increase in productive capacity - increase employment - more income it generates – more demand is made – demand in turn derives investment. This creates a virtuous cycle.

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