Vote Brexit, profit from lower pound

How to correct the current account deficit

by Brian Reading in London

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Remainers say a Leave victory will be apocalyptic. Stay in the European Union after the 23 June referendum, and the outlook is rosy. Brexiteers claim a positive scenario on leaving. Nobody sees that the prospects are dire whichever way the vote goes.

The British economy is unbalanced. This inhibits growth. Recession looms in the next two years. The issue is which option – 'in' or 'out' – is more likely to address unsustainable disequilibrium. My conclusion: 'Brexit' is a better way to address Britain's imbalances. Remaining in the EU would make them worse until the next crisis.

UK Treasury forecasts, indeed almost all official forecasts, promise stable growth if a Brexit defeat restores confidence. The Treasury's forecasting models remain Keynesian, paying lip-service to monetary factors. Financial balances and balance sheets are thought of as inconsequential. Treasury officials failed to forecast the 2008 crisis and subsequent recession. Perversely, they are sticking to discredited models.

The 2008 crisis was caused by households' excessive deficits and unsustainable debt leading to deleveraging and depressed demand. Fiscal profligacy then shifted the excessive deficits and unsustainable debts to the public sector, borrowing demand from the future.

Retrenchment inevitably followed, with prudence subtracting the demand previously borrowed. Central banks took up the running with monetary profligacy. The aim was to encourage households and companies to borrow and spend again.

The success of the policy was to drive a wedge between inflated asset values and underlying economic fundamentals. The Office for Budget Responsibility's March 2016 budget forecast assumed household debt would climb back to near its pre-crisis peak, ensuring continued moderate growth while the budget deficit was eliminated. This can't and won't work.

The large UK current account deficit is the problem. This represents foreigners' financial surplus, the extent to which they lend the UK their excess savings to pay for their surplus products. As long as foreigners run a surplus, the domestic UK economy must run up debts. If the British government cuts its borrowing and spending by retrenchment, households or companies must borrow and spend more to maintain demand and growth.

Without a reduced current account deficit, the debt problem cannot be solved by transferring the borrowing elsewhere in the economy. There is a limit to building up foreign debts.

One way to reduce the current account deficit is to depreciate the currency to increase exports. The other means is to engineer a recession so imports fall. Greece, Spain and Portugal know this to their cost.

If Britain remains in the EU, this will encourage more financial inflows and buoy sterling. Monetary profligacy will continue. Domestic debt will rise further. The damage will be horrific. Monetary profligacy is undermining pension funding and banks' balance sheets.

The inflection point comes when the current account deficit gets so large and domestic debt so onerous that confidence evaporates – which could have an explosive effect on the pound. What is needed, though, is a gradual sterling depreciation. Brexit would produce just that effect.

The currency may spike down in the first reaction to a Leave victory. But once the financial markets realise that Brexit does not bring the UK's immediate and inevitable departure from the EU, sterling will bounce back as short-sellers take profits.

Fickle foreign investment is more of a curse than a blessing. One of the major reasons for the record peacetime current account deficit is a collapse in Britain's foreign investment income – reflecting Britain's superior economic performance relative to the anaemic EU recovery.

The pound’s depreciation will increase the sterling value of foreign income, another factor helping to correct the current account. Policy-makers and the electorate should welcome, not fear, sterling depreciation. Brexit is the way to achieve it.

Brian Reading was an Economic Adviser to Prime Minister Edward Heath and is a Member of the OMFIF Advisory Board. This is No.93 in the series – the 100th article will appear on 23 June.

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