

## **Unbalanced:**

The Intersection of Growth and Balance of Payments Resolution Models

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**Abstract:** Every national economy faces two imperatives: (1) the need to generate output; (2) the need to secure sufficient foreign exchange (forex) to pay for spending abroad. Political economy possesses numerous heuristic approaches to the former imperative but lacks one for the latter. This paper tries to fill that gap by identifying five ‘models’ for resolving the balance of payments. I maintain that a more sophisticated language for understanding the balance of payments provides analytical traction on two key political economy problems: (1) the viability of macroeconomic strategies focused on maximizing current account surpluses, and (2) the meaning of intra-eurozone imbalances in the TARGET2 system. Moreover, it improves our understanding of how economic shocks affect economies differently, as particularly evident in the Covid-19 pandemic.

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Every state economy faces two imperatives: (1) the need to generate output; (2) the need to secure sufficient foreign exchange (forex) to pay for spending abroad. The importance of the first constraint is obvious enough: without productive output, an economy generates neither employment nor even the most basic of goods to sustain the existence of its people. However, the second constraint is nearly as important: without an ability to earn forex, an economy can only consume what it produces (i.e., it exists in a state of ‘autarky’). For some large and diversified economies – which incidentally host much of the higher education system responsible for training the global economics profession – the second constraint can be overlooked to some degree. While autarky might raise domestic prices for United States consumers, it would not threaten the viability of the USA itself – especially given the status of the dollar as a global reserve currency. The situation is very different in smaller economies with no domestic sources of key goods – especially states dependent on food and energy imports. Even medium-to-large economies would struggle to produce the full range of manufactured goods on which contemporary society has grown dependent.

Political economy possesses a sophisticated language – refined over many years – for discussing the first of these imperatives. Over the past two decades, the most notable of these have been anchored by Peter Hall and David Soskice’s *Varieties of Capitalism* (VoC) framework and, more recently, by Lucio Baccaro and Jonas Pontusson’s *Growth Model Perspective* (GMP). However, there is no analogous language for discussing the second constraint, no ‘varieties of balance of payments resolution strategies.’ Nor is the concern over where forex comes from a topic that can be easily subsumed into existing growth-focused frameworks. At best, we see references to ‘deficit’ versus ‘surplus’ countries, implicitly referring to trade as the primary mechanism for generating (or spending) forex. This is a severe limitation: for many economies around the world, trade is a relatively peripheral part of their balances of payments. Accordingly, this emphasis on the current account – specifically on trade – has major real-world implications.

The purpose of this paper is to develop a language for discussing balance of payments (BoP) resolution strategies. It does so with the conscious aim of making this approach an easily applicable add-on to existing institutionalist accounts of systemic capitalist diversity. This paper does not make any causal claims. Rather, it is primarily concerned with providing a taxonomy of BoP resolution models and demonstrating that this is, in fact, a valuable scholarly task. I argue that the value of this approach is illustrated by how it explains things that we would miss without it, or provides better understandings of real-world phenomena

than we presently possess. This article therefore necessarily adopts a more interpretivist sensibility.

The first section of this paper explains the two imperatives in detail, with special emphasis on why they are, in fact, *imperative*. The second section develops a heuristic system for understanding an economy's BoP resolution model and how those models interact with an economy's growth model. The third section concludes by demonstrating that an equal consideration of the two overriding economic imperatives provides better traction on key real-world questions. In particular, I focus on two: (1) the viability of macroeconomic strategies focused on maximizing current account surpluses, (2) and the meaning of intra-eurozone imbalances in the TARGET2 system. The final section concludes with observations on how a heuristic system focused on the second imperative will help us better forecast the consequences of Covid-19.

### **I: Two Imperatives**

The first imperative – the need to generate output – can be dealt with relatively quickly because few would dispute its importance. Economies must make and do things in order to sustain human needs. This is reflected in the most widely-used macroeconomic variables employed by policymakers, academics, and the lay public. Gross domestic product (GDP) and (un)employment are arguably the two most important of these – and both are directly connected with production. GDP is itself a measure of output (as well as the income associated with producing that output) and employment reflects how many people are integrated into the productive process.

As a discipline, Comparative Political Economy (CPE) has a long history of assessing how economies produce and grow output. The VoC remains a dominant force in institutionalist CPE, with over ten thousand Google Scholar citations, a slew of subsequent articles with some “varieties of” formulation in their titles (c.f. Schwartz and Seabrooke 2008; Baker 2014; Van Gunten and Navot 2017), and its own cottage industry of rebuttals and reformulations (see Streeck 2010 for a discussion). the VoC literature holds a place of hegemonic importance among CPE scholars. While the general notion of comparative advantage goes back at least as far as David Ricardo, the VoC approach brought far more complexity to the concept, pushing against the notion that such advantages arise solely from factor endowments, human capital differences, or demand conditions. In the VoC world, firm-labor relations, education systems, financial markets, and a host of other institutional factors work to determine comparative advantages. At the same time, the VoC approach also has

shortcomings: its understanding of contemporary financial markets is relatively unsophisticated (Hardie et al. 2013), it tends to generate overly stylised and static categories (Streeck 2010), and it usually focuses on inter-firm and state-firm dynamics rather than on the economic activity of households – who are generally seen as labor rather than as drivers of economic activity (Fuller, Johnston and Regan 2018).

In a key critique, Baccaro and Pontusson (2016) challenged CPE scholars to move away from the supply-side emphasis of conventional VoC work and toward a Post-Keynesian-influenced emphasis on demand. Rather than seeing countries as possessing relatively static institutional arrangements, they argue that we should recognise that economic policymakers are constantly seeking growth in an environment of stagnant real wages. The objective of these policymakers is to achieve this by managing the demand side of the economy – though each system is dealt different hands to play. Soskice and David Hope (2016) responded positively to Baccaro and Pontusson’s intervention – particularly their emphasis on demand – while questioning the degree to which their approach represented a true break with VoC tradition (as well as their emphasis on Post-Keynesian economic logic).

### *The Second Imperative*

Both the VoC and GMP tend to overlook the role of the second imperative. When considering forex at all, both focus on the trade balance to the exclusion of most other considerations, further emphasizing goods exports rather than more intangible services exports. This conflation of foreign economic relations with trade relations (particularly trade in goods) is a mistake. From this perspective, there is really only one viable BoP resolution model: export-led growth. Under such regimes, economies produce and sell more to the rest of the world than they buy from it, addressing both the need for productive activity and forex from abroad. In short, many of the goods and services a society requires are made and sold at home – driving up domestic income – while the excess can be sold abroad in exchange for crucial forex. That forex then allows for the purchase of any goods and services that an economy does not make for itself.

This way of understanding the second constraint is rooted in history and conventional wisdom, likely because trade flows have dominated international exchange for most of human experience. In effect, trade balances have typically cleared ‘first’ in the minds of political economists: if a state does not have sufficient revenue from exports to pay for its foreign spending, it must borrow the forex it needs. Within such a system, nearly all international payments flows are directly related to trade: you can only borrow forex in period t-1 if you

could credibly promise to produce more export goods in period  $t$ , earning the funds necessary to repay the original debt. This very simple framing of the BoP still wields influence today: for many, states can either ‘earn’ more than they ‘spend’ (ostensibly, current account surplus countries) or ‘spend’ more than they ‘earn’ (current account deficit countries). From this perspective, the former is always preferable to the latter because a surplus country is already satisfying both constraints in the present – while a deficit country is gambling on its ability to meet both in the future.

This understanding of the balance of payments stems in part from the decline of the BoP as a salient target of economic policy over the final decades of the 20<sup>th</sup> century and beginning of the 21<sup>st</sup>. In much of the world, the BoP began fading from public consciousness following the end of the Bretton Woods system and the general shift away from fixed exchange rate regimes. Under a fixed exchange rate, if demand for a currency is too strong at the exchange rate selected by the authorities, the country will have to provide additional local currency to markets in order to mitigate appreciation pressures. Conversely, if demand for a currency is too weak at the pegged rate, the authorities must buy their own currency (selling their foreign reserves) in order to counteract the pressure for depreciation. While surpluses can theoretically be maintained almost indefinitely (there are limits we will address later), deficits are subject to a harder constraint: a fixed exchange rate under depreciation pressure can only be maintained so long as the authority in charge of the regime continues to buy its own currency. And it can only do this as long as it possesses enough forex to make those purchases.

Faced with a BoP deficit – which refers to an overall shortage of forex, not simply a trade deficit – economies conventionally either had to either devalue their currency or severely cut back on spending in an attempt to engineer an ‘internal devaluation’ (i.e., wage reduction). Both approaches reduce spending on imports while making exported goods more competitive. Either way, the negative effect on the domestic economy is highly visible and open to politicization. A sudden currency devaluation makes imported goods more expensive overnight, harming supply chains dependent on imported inputs and reducing the real incomes of everyone earning the currency being devalued. Furthermore, running out of foreign exchange is a clear policy failure – one which often results in the politically lethal necessity of receiving conditional assistance from official lenders like the International Monetary Fund (IMF). By comparison, adjustments under floating exchange rates tend to be more gentle and less politically disruptive – a core point used by Milton Friedman to advocate for them. Perhaps more importantly, the adjustment under floating exchange rates takes place through

the market, whereas the adjustment under fixed exchange rates must be actively determined by governments and subject to political considerations.

Even as it has faded from political prominence in our mostly-floating world of 2021, the BoP remains a crucially important constraint on state action. A useful example comes in the form of North Korea, which is arguably the most BoP-constrained state in the global system. North Korea struggles to produce everything it requires for domestic consumption, meaning that it needs to (or at least would very much like to) import goods. However, the country cannot simply buy products from abroad with their domestic currency, the North Korean won. Foreign sellers will not readily accept won as it is not used in global commerce, so North Korea must have a way to make payments that will be accepted by foreign sellers. Broadly speaking, it has two normal options for generating such foreign funds: exporting and borrowing. However, because North Korea struggles to raise sufficient forex through either of these means, the regime has been forced to find more creative ways to meet their forex needs. These have included smuggling drugs and weapons, counterfeiting foreign banknotes, and even operating a global chain of North Korean-themed restaurants where all foreign currency revenue is shipped back to Pyongyang (Nanto 2009; Strangio 2010; Bechtol Jr. 2018; Ives 2019).

There is another major example of contemporary economies finding themselves facing strict, politically fraught, BoP constraints: the eurozone. This is because national authorities can no longer devalue their own currencies, eliminating one easy mechanism for reducing the cost of exports and making it easier to earn forex from abroad. If eurozone countries wish to spend funds abroad, they must either convince financial markets to lend to them or improve their export performance. The challenge is that, absent an exchange rate, the only way to drive down export prices is to cut exporters' costs – typically through wage bill reductions. This can exacerbate economic difficulties and make it harder for the country to borrow on private markets – and it makes the BoP into a highly visible and contentious constraint on policy. During the 2010s eurozone crisis, economies like Greece were forced to both rely on official assistance in order to replace missing forex inflows and engage in austerity measures in an attempt to achieve internal devaluation. Both were driven by the second constraint more than the first. What is more, meeting the second imperative actually constrains economies' options for solving the first. That is, a lack of forex can make it more difficult to reconfigure an economy to produce different goods for export. Prior to the pandemic, Greece had nearly 'successfully' restored a current account surplus – but only by wiping out more than 15 years

of growth in order to drive down imports and inflation. In other words, they balanced their BoP by driving down their need for forex rather than attracting more.

Whether discussing a troubled economy with a floating currency or mostly healthy economies lacking exchange rate flexibility, the second constraint – the need to earn forex – is clearly a real and powerful limitation on state action in the 21<sup>st</sup> century. Political economy requires better tools for understanding and communicating this reality.

## **II: A Taxonomy of BoP Resolution Models**

A common thread running through the VoC and GMP literatures is a fondness for heuristic categories. Where the VoC has liberal and coordinated market economies, the GMP has consumption-led and export-led growth. I propose here that we can benefit from the same approach to forex access. Doing so focuses our attention on the Balance of Payments: the official record of all cross-border payments into and out of an economic system.<sup>1</sup> The BoP disaggregates forex inflows by the type of transaction and assesses where the largest forex inflows are. This section of the present paper uses the BoP to identify five major strategies for bringing in foreign exchange – conventional export-led growth, tourism, export of financial products (often combined with financial services), *rentier* income, international aid. There is also the possibility of possessing no viable strategy, leaving an economy in constant crisis.

It is important to note that these strategies are not always mutually exclusive. Some Caribbean tourism-exporters also export financial services – and some financial services exporters will generate large *rentier* incomes. It is also important to keep perspective when working with BoP data: it is often of exceedingly low quality despite its importance and extensive reporting (Linsi and Mügge 2019). As a result, we are primarily looking for major trends evident over many years rather than year-to-year fluctuations in individual accounts. Indeed, one of the major concerns with regard to BoP resolution is that these strategies have become relatively sticky – with countries like Germany or the United States seeing very little change in their BoP balance and composition over time.

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<sup>1</sup> All of the balance of payments figures in this paper from this point, except where specifically cited, is drawn from the IMF's Balance of Payments database and the BPM6 guidelines for aggregating Balance of Payments data.

### *Export-Led Growth*

The most common means of attracting forex is the export of goods. It is therefore not surprising that existing heuristics for capitalist systems often limit their interest in international balances to these transactions. There are, of course, important differences between export specializations: the export of primary commodities has very different implications from the export of manufactured goods, for instance. Irrespective of the specific goods being exported, however, there are distinct advantages to relying on exports to provide both growth and forex.

Fewer than half of the world's countries run a trade goods surplus; however, this is the largest source of net forex inflows for many of them. In recent years, China and Germany have accounted for the two largest goods surpluses. While China's has shrunk since earlier in the 2010s, it still amounted to just over \$400bn by 2019; Germany's surplus has hovered around \$250bn for most of the decade. While the overall size of a surplus (or deficit) does matter, these are not the largest trade imbalances relative to economic size. For instance, Azerbaijan's \$8.35bn surplus in 2019 is far smaller nominally but amounts to more than 12 percent of GDP (as opposed to just over six percent in Germany).

One major advantage of resolving the national need for foreign exchange by exporting goods is that exports directly generate economic growth. That is, an export-oriented strategy satisfies both imperatives, killing two birds with one stone (by comparison, selling financial products does not directly influence the real economy). A second advantage is that the free flow of goods is far more entrenched in the international system than flows of services, people, or capital. Whether looking at the pre-WW1 gold standard, the Bretton Woods system, or today's post-Bretton Woods world, substantial trade flows between countries has been a constant in international economic relations. By contrast, capital flows were severely curtailed for much of the Bretton Woods era – and despite capital controls falling out of favour at the dawn of the neoliberal era, numerous researchers (including at the IMF) have concluded that capital controls can be beneficial under certain circumstances (Chwieroth 2008; Gallagher and Ocampo 2013; Grabel and Gallagher 2015). Tourism is arguably even less reliable than capital inflows, with people generally subject to much more stringent conditions than either goods or money when moving around the world – as has been readily apparent during the Covid pandemic.

Aside from these advantages, there are problems associated with the policy settings that contribute to an advantage in exports. One is that export-led growth can encourage domestic wage suppression, excessively high savings, and limited investment. In



contemporary Germany, for instance, there is a strong argument that its export performance has come at the expense of long periods of domestic underinvestment (Fratzscher 2018). Moreover, the reliance on a highly productive exporting sector can foster a dualization of the exporter's economy, where workers employed in the highly productive export sector earn far higher incomes than those employed in the far less productive non-tradeable sector, which relies more on domestic consumption and government savings to raise revenue.

### *Tourism*

If export-led growth conventionally emphasises the export of goods, there are alternative BoP resolution strategies that emphasise the export of services. We will deal with the export of financial services next – but first, we must look at another prevalent form of alternative export-led growth: tourism. Like export-led growth, this takes relatively little explanation: when a person travels abroad, any spending they do ultimately necessitates bringing foreign funds across a border. Therefore, at least in principle, all of the transportation, food and drink, accommodation, and small purchases a visitor makes should be counted as a services import (for the visitor's home country) and an export (for the country visited).

The countries that are most dependent on tourism to provide forex as well as output are unsurprising, with countries like Macau, Palau, the Maldives, and Grenada topping the list. Consider the Maldives: its tourism receipts in 2019 amounted to approximately \$3.2bn, which accounts for nearly 60 percent of the entire country's output and single-handedly covers the economy's \$2.4bn goods deficit (meanwhile, goods exports account for a mere \$360m in forex, and inward FDI for \$900m). This is not merely a phenomenon that affects island paradises, however. A modest mid-sized economy like Croatia's also draws in as much forex from tourism spending than from all goods exports combined – accounting for 20 percent of GDP and almost precisely balancing the country's deficit in goods. Even a large economy's like Turkey managed to grow tourism receipts to the extent that it reduced the demand for forex to finance current spending by 14 percent between the 1980s and 2010s (Çelik et al. 2013).

While such tourism-dependence could technically be thought of as export-led growth, the comparative advantage Germany holds over Greece in the production of machine tools is completely unlike the comparative Greece holds over Germany in selling sand and sunshine. Generally speaking, there are more disadvantages to relying on tourism. Whereas the production of goods is a high-productivity enterprise in which markets exert constant pressure to increase efficiency, tourism is generally seen as a low-wage, low-productivity sector in

which efficiency of production matters less than a country's unique locales. As such, you might expect long-term growth to be relatively slow for tourism-based systems (notwithstanding the potential for changes in demand conditions). The product that a tourism exporter "sells" is also not as easily altered to suit market preferences as it is for a seller of manufactured goods, potentially making it harder for tourism exporters to attract forex if customers demand a different sort of travel experience. If the globe develops a travel craze for visiting mountains, the Netherlands would struggle to generate much interest. Additionally, as noted in the advantages of conventional export-led growth, tourism revenues have proven highly sensitive to disruptions to the international movement of people, such as the global spread of an infectious disease.

### *The Financialised Approach*

The financialised strategy to addressing the second constraint is far more complex than the two strategies discussed so far. In this sketch, I focus on three elements of a finance-focused approach to attracting forex: (1) the export of financial claims on domestic institutions, (2) the reselling of financial claims on foreign institutions, and (3) the sale of financial services and advice concerning the purchase of financial products.

There are different sorts of financial flows classified in the BoP, distinguished by the type and purpose of transaction. Inward financial flows are generally broken into foreign direct investment (FDI), foreign portfolio investment (FPI) and other investment. FDI – in which a foreign entity buys a substantial stake in a business – has traditionally been more sought after as a source of forex because deeper financial links are less likely to be dissolved over short-term problems. By contrast, FPI and Other Investment are often referred to as 'hot' money – representing cross-border financial flows where the asset-holder is seeking a purely financial return. Other investment is predominantly constituted of cross-border bank deposits. Poorer economies with less-developed banking systems tend to have large outflows in this category (captured by the accumulation of assets in the BoP), while banking centres account for the matching inflows (liabilities).

Further complicating matters is that many economies specialised in managing these financial flows function as intermediaries, receiving investment flows, repackaging them, then sending them back out into the world. The Netherlands, for instance, is one of the global leaders in FDI, with both inflows and outflows regularly exceeding \$200bn annually. However, the Dutch *net* position with respect to FDI is typically very small, with the inflows and outflows tracking each other closely. Luxembourg, has inflows and outflows of FDI both

amounting to more than ten times its annual GDP of around \$70bn. All of this helps to sustain a deficit in trade goods that amounts to nearly \$2,000 per capita each year.

In addition to capital flows themselves, financial centres also earn forex (and generate output) through the export of financial services. This is a current account phenomenon, as opposed to the financial account phenomena discussed in the paragraph above. For example, if Zuzana from Slovakia opens a bank account in Austria, the deposit would go into the BoP as other investment (an asset for Slovakia and a liability for Austria). However, if Zuzana pays her Austrian banker for financial advice, that payment would go into the current account as a services transaction (import for Slovakia, export for Austria). While capital flows and financial services exports are very different sorts of cross-border forex movements, they tend to be complementary and warrant discussion together. Luxembourg, for instance, earns so much revenue from the fees associated with capital in- and out-flows that financial services account for nearly 90 percent of the country's output.

Economies like the United Kingdom and United States have large financial services sectors; however, it tends to be smaller economies – especially international financial centres (including offshore centres) – that become dependent on this sort of economic activity to meet both imperatives. Accordingly, while we may think of Switzerland or the UK as international financial capitals, this sort of reliance is most pronounced in cases like the Cayman Islands or Panama.

### *The Rentier Approach*

While relatively uncommon, an additional strategy that demands consideration – especially over longer time horizons – is relying upon forex generated as *rentier* income. This refers to income generated by financial investments, captured within the current account of the BoP under the category of Primary Income. Economies which have had longstanding current account surpluses, by virtue of having reinvested their forex back into the wider world over many years, generally earn large amounts of income from their investments. This income generally takes the form of dividends on equities and interest paid on debt securities and loans.

A conspicuous example of this sort of strategy is Norway. Owing to its many years of oil exports, Norway has accrued a very large supply of income-generating foreign assets. As a result, the country's 2019 current account surplus - \$16bn – was roughly equal to the net investment income earned from past Norwegian investment abroad. That is, Norway earned more forex on a net basis from investment income than it did from current oil exports.

Especially as oil reserves fall, Norway will grow even more dependent on the income generated by the financial products purchased with the proceeds of past oil revenue. In effect, the country is in the process of transforming its resource wealth into wealth in income-bearing financial assets: a *rentier* approach. The situation is similar in Kuwait, where investment income accounts for nearly a quarter of GDP and is the largest net contributor to national forex supplies.

### *Dependence on Unilateral Transfers*

Lacking better options, some countries rely heavily on official or individual unilateral transfers in order to satisfy the second imperative. Some of this appears in the typically small Capital Account, which tallies official asset transfers between governments; this includes some flows not exclusively thought of as aid, such as the EU's structural and cohesion funds. The other form of gift that can be crucial to an economy's balance of payments comes in the form of individual remittances – such as the funds sent home by migrant workers – which are included in the BoP as Secondary Income.

In many cases, the two types of forex inflows come together – though generally the private transfers are more economically significant. In the example of the Palestinian territories, several hundred million dollars in regular aid inflows is supplemented by over \$2bn in remittance inflows annually, with those unilateral income transfers accounting for the largest source of forex in the West Bank and Gaza by some distance. The same is true in many small Central American countries: El Salvador's near-\$6bn in 2019 remittance inflows account for more inward forex flows than any other source (the country exports less than \$5bn in goods), representing more than one fifth of national output.

More than some of the other strategies for attracting forex discussed in this section, there has been a fair amount of research into the specific consequences of relying upon remittance flows (c.f. Amuedo-Dorantes 2014; Sutradhar 2020). Clearly, access to such transfers eases the constraints on recipient countries to earn forex in other ways – and provides a key source of income for many families. However, remittance flows can also fuel inflation in local markets for non-tradeable goods and discourage active participation in the local labor force. Remittances are also relatively vulnerable to some of the same issues facing tourism-based models, since remittance flows always involve the international mobility of people and are vulnerable to controls on migration.

### *No Viable Approach – a ‘Busted’ Model*

Of course, just as there are countries which fail to generate much output and economic activity, there are systems that struggle mightily to meet their forex needs. This often happens when an existing strategy for bringing in Forex ceases to function – for example during a sudden stop, where capital inflows dry up as outflows increase. Cutting off an economy’s access to forex in this way leads to one of two outcomes, depending on the currency regime of the stricken country. With a floating exchange rate, a country can allow the reduced demand for its currency to cause a depreciation in the hope that this will drive exports up and imports down. If operating a fixed exchange rate, the authorities must either abandon their fixed exchange rate or provide forex to their domestic system from their accumulated savings of forex (i.e., reserve assets). They can only continue to do this as long as they have forex to spend, however.

When an economy is truly unable to meet its forex needs through any conventional method, it faces a starker choice: uncontrolled currency depreciation (potentially cutting off access to foreign-produced goods) or official borrowing from a ‘lender of last resort’ (most commonly the IMF) who will provide short-term access to forex in exchange for structural reforms designed to rectify the original forex shortfall. Both choices present political and social difficulties – and countries cannot remain in such a position indefinitely, with IMF programs meant as time-bound support. The most sustainable form of ‘busted’ forex model is arguably limited to eurozone countries accumulating TARGET2 liabilities – addressed in the next section.

### **III: The Value of a BoP-Centered Approach**

There are several ways to justify this approach to understanding capitalist systems. There may be differences in outcomes associated with varying approaches to solving the second constraint. This paper is clearly written in the expectation that such divergence is likely to be present; however, an analysis of such causal mechanisms is not the key focus here. Instead, I argue that this approach – building a language and descriptive taxonomy specifically focused on the macroeconomic importance of the BoP – allows us to better understand real-world phenomena by focusing providing a higher-quality understanding of those phenomena. This section presents two areas where an explicit focus on BoP resolution helps us to see things we might otherwise miss: (1) the self-defeating nature of policies focused on maximizing current account surpluses as a policy objective, and (2) the role of TARGET2 in the resolution of intra-European BoP imbalances.

### *The Myopia of Neomercantilism*

One of the hardest things to intuitively understand about the BoP is how current account surplus countries are constrained. While it is obvious that a state cannot run an external deficit in perpetuity (they will eventually run out of internationally acceptable currency to spend), it is less obvious why states cannot run external surpluses forever. It is true that the pressure on a country struggling to raise forex is much greater than the pressure felt by a country awash in foreign currency – but that doesn't mean the second constraint disappears. The problem for these countries is twofold: first and more straightforwardly, their surplus is in the wrong currency for domestic use. A Japanese banking system awash in US dollars provided by American importers needs to put those dollars somewhere abroad, unless they plan on putting the funds beneath the proverbial mattress or permitting the circulation of a second domestic currency. Holding large sums of foreign currency in a metaphorical room – conjuring images of cartoon vaults – is unfeasible since that money would earn zero return and slowly lose value to inflation. Instead, extra forex gets recycled back into the international system as savings. So, the Japanese banking system uses their 'excess' dollars to – for example – buy US government bonds. This can be a challenge when a country, for instance China, possesses so much foreign currency that it struggles to find sufficient assets for purchase.

A second problem is sustainability. As Martin Wolf (2008; 2013) has repeatedly pointed out in the context of the eurozone crisis, the existence of current account surplus countries is predicated on the existence of current account deficit countries. You cannot have a Germany- or China-sized surplus without a United States- or United Kingdom-sized deficit. This dynamic is crucially important because it explains why net exporters are constrained by the second imperative even if they have access to more forex than they can use. If countries with trade surpluses do not find ways to recycle their extra forex back out into the world through lending, the foreign spending that generates their surpluses in the first place will eventually disappear.

Consider a stylised example of a two-country world. If Country A runs a trade deficit with Country B, they will be spending more than they earn. Where does that excess come from? For a while, Country A might have savings that it can use to meet the shortfall – and they might have some forex-like assets that they can use for payment (e.g., gold). But when those savings run out, the only way Country A can spend more than it has is by borrowing. And the only available lender is Country B. This is the bind: if Country B refuses to lend its

extra earnings back to Country A, *it destroys the source of its own surplus*. Moreover, it might also force Country A into default on previous borrowing from Country B.

This stylised example is itself limited, since it essentially assumes that the trade balance clears ‘first’ and all other forex transactions are shaped by a need to address either a trade surplus or deficit. This is a key analytical mistake that pervades academia and policymaking circles. As we have seen, trade is only one way to gain access to forex – and in some cases, capital flows affect the trade balance rather than vice versa. An additional problem is more political: if we accept the mercantilist premise that exporting is “good” and represents an appropriate target of policy, that position inherently generates conflict. This is because the existence of trade surpluses in one country *requires* the existence of trade deficits somewhere else. If only some countries can achieve the safety of being exporters, the competition becomes – literally and idiomatically – zero sum. Within the eurozone, the Dutch-German view of current account surpluses as intrinsically superior to current account deficits has contributed to the deflationary bias of post-crisis reforms and ultimately generated a great deal of intra-EU tension. Observers such as Wolf (2013) have noted that the German position entails turning the whole of the eurozone into a scaled-up version of Germany – even if the German strategy is not appropriate (or not possible to achieve) for all.

Furthermore, a case like Brazil nicely illustrates the limitations of such a limited vocabulary. Brazil has had a trade surplus in goods since 2015 and in goods and services combined since 2016. However, the Brazilian current account deficit has expanded markedly since 2016, reaching more than \$50bn by the end of the 2010s. This necessitates substantial foreign borrowing and, especially in recent years, liquidation of Brazilian reserves. The problematic part of the Brazilian BoP stems from being on the opposite side of the *rentier* relationship from a case like Norway or Kuwait. Brazilian payments on past borrowing have doubled since 2015 even as the trade deficit shrank. The same can be said for Ireland – constantly subject to low-quality analysis due to its highly irregular BoP: like Brazil, Ireland often runs a current account deficit despite a net goods surplus of more than twice the size of its overall deficit. This is made possible, again, by the enormous outflows in primary income, arising from the explosive growth of the Irish financial sector in previous years.

What a BoP-focused heuristic approach to capitalist variety ultimately reveals here is a fundamental flaw in the export-driven growth model that is otherwise invisible: over longer time-horizons, it is only sustainable through the growth of liabilities in trading partners. For David Hume, the self-defeating nature of bullion-seeking mercantilism operated through inflation. In the modern financialised global economy, the self-defeating nature of pursuing

export-led growth operates through encouraging indebtedness, political tension, and eventually financial crises.

### *The Role of TARGET2*

A second and uniquely European application of this perspective gives us traction on one of the more confusing elements of the eurozone: the Trans-European Automated Real-Time Gross Settlements Express Transfer System, or TARGET2. This system is what allows someone in Spain to buy a product from someone in the Netherlands, with the transaction instantaneously showing up in both the buyer and seller's accounts. What occurs is a complex electronic shuffling of assets and liabilities between the two countries' financial systems and the broader Eurosystem, including both the ECB and all euro-using national central banks. When a Spanish person makes a purchase, it reduces the liabilities of their local bank by the amount deducted from the Spanish buyer's bank account. The bank can now transfer the purchase price out of their own deposits held at the Spanish central bank. These funds move through the Eurosystem from the Spanish central bank's account with the ECB to the Dutch central bank's account. The Dutch central bank then adds the transaction amount to the local Dutch bank's deposits, which allows that bank to deposit the transaction funds in the account of the seller. Through this process, a Spanish claim on the Eurosystem (the collective composed of the ECB and all member states' central banks) is converted into a Dutch claim on the Eurosystem as the money disappears from the Spaniard's account and appears in the account of the Dutch seller (for a much fuller exploration of the mechanics of TARGET2, see Cecchetti, McCauley, and McGuire 2012).

What makes TARGET2 special from the BoP perspective is that it allows EMU member states to partially bypass the BoP constraint and spend more than they earn from abroad. If a typical country tries to spend more foreign exchange than they earn, they will eventually reach a point where there is simply no forex within that system left to pay for anything. This sort of automatic shutoff mechanism would be extremely problematic in the highly integrated eurozone: it would cause chaos if all of the payments coming from one member state suddenly began to "bounce" due to a lack of funds within the economy as a whole. Instead, what happens is that countries can accumulate positive or negative TARGET2 balances, effectively owing – or being owed by – the Eurosystem.

Returning to our Spanish buyer, if they and the rest of the country collectively spend more than the nation's financial system possesses, the Spanish central bank can provide the extra funds needed by lending to its commercial banks. The Spanish central bank then



effectively issues an IOU to the ECB, which transfers it to the Dutch central bank's balance sheet as an interest-bearing asset. In other words, the Dutch central bank has effectively lent that money to the Spanish central bank, meaning that Spain owes the ECB and the ECB owes the Netherlands. The result is that a country in the eurozone can spend an almost unlimited amount of money elsewhere in the eurozone so long as the ECB allows it. Figure 1 depicts the evolution of TARGET2 balances since 2001 for the eurozone countries with the largest balances (positive and negative). Germany has, by far, the largest positive balance – reaching over a trillion euros in recent years (though pay some mind to the enormity of Luxembourg's balance, given its tiny size). On the negative side, the Greek and Irish balances which once caused consternation in the early 2010s have since become dwarfed by the growth of negative balances in Spain and Italy.

<<Insert Figure 1 Here>>

While non-EMU states resolve their BoPs by attracting foreign payments through exports and/or borrowing, what this graph shows is that EMU states have an additional option: they can also “resolve” their BoP by running up TARGET2 balances. Of course, this is politically problematic within the eurozone, where any suggestion of transfers between member states viewed by suspicion – especially in Berlin and the Hague. Indeed, some observers see the accumulation of TARGET2 balances as tantamount to a “stealth” bailout of crisis-stricken countries, softening the pressure to engage in painful but necessary economic reforms (Sinn 2011). This suggestion has generated substantial debate. One area of dispute is over whether rising TARGET2 balance should be thought of as irresponsible borrowing and spending by debtors, or as reckless lending arising from creditors' demand for saving (Grauwe and Ji 2012). Another contested topic centres on what would happen to member states' TARGET2 balances in the event of the euro collapsing (Whelan 2012). This paper is generally neutral on these debates. While it adopts the “BoP view” that TARGET2 balances represent a means of financing a BoP deficit, it assumes that this can arise from any number of causes, including irresponsible spending as well as balance sheet manoeuvring in response to liberal ECB policy or institutional design failures (Febrero, Uxó, and Bermejo 2018).

Taking a step back, this debate appears to be largely normative: while both sides agree on many of the technical facts and the policy tools available, they disagree over questions of blame (i.e., if a financial transaction goes wrong, is it the fault of an irresponsible borrower or an irresponsible lender?) and over the wisdom of certain policy responses. This reflects the

fact that TARGET2 is a politically constrained mechanism for resolving BoP shortages. Indeed, there is no practical way to force a restoration of balances to zero short of a massive trans-European effort at repossession. Instead of attacking the balances directly, creditor countries have essentially forced debtor countries to indirectly reduce their TARGET2 liabilities (i.e., their BoP deficits) by implementing austerity-minded structural reforms.

Returning to the value of identifying the second imperative, the tense cross-eurozone formation of from these policies in the 2010s can be seen as a protracted attempt to negotiate a solution (in this case, a reduction of outstanding TARGET2 balances) through technocratic tinkering and political negotiation rather than a market mechanism.

#### **IV: The Long Shadow of Covid: A Conclusion**

The core argument throughout this paper has been that practical understanding of economic policy must account for both how an economy grows and how it attracts forex. The economic impact of Covid will almost certainly vary based on both growth and forex models – providing a forward-looking third area where a new heuristic approach to forex may be valuable. Indeed, we arguably *must* consider both institutional configurations when examining the impact of a shock like Covid.

The most obvious illustration of this comes from more tourism-reliant economies, where growth models and forex resolution models would be expected to have confounding effects on the BoP. Considering output alone, reductions in national income and consumption push current account balances toward surpluses. This is because lower consumption generally means fewer imports, resulting in less outbound payments. On the other hand, the collapse of tourism reduces inbound payments, pushing economies towards current account deficits. This is because fewer tourism exports necessarily reduce the current account balance. The relative impact of these two countervailing forces will help to determine the degree to which Covid causes current account deficits.

Looking at the EU, the five most tourism-dependent economies have historically been Croatia, Cyprus, Greece, Portugal, and Spain.<sup>2</sup> In Covid-affected 2020, all five experienced declines in their current account balances. In all five cases, the most substantial driver of this shift was a decline in tourism exports, only partly offset by declining imports. In the case of Greece, for instance, the goods balance actually moved toward a surplus as a result of cratering imports, while the decline in tourism dropped its services balance from \$23.5bn to

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<sup>2</sup> Based on average contribution of tourism to GDP as calculated by the World Bank from 1995 to 2018

\$8.5bn. The same is true for Portugal, Cyprus, and Spain (Croatia experienced a reduced goods trade balance, though the decline in its services trade was more severe). In less tourist-dependent Germany – itself experiencing a reduction in its current account surplus – the pattern is reversed. There, the goods balance fell \$25 billion while the services balance actually improved, due to partly to a decline in spending on foreign holidays. Services balances similarly grew more positive in other colder Northern European locales, such as Belgium, Denmark, and Finland.

In short, while goods imports and exports have generally declined across the board during the pandemic, there are divergent consequences for tourism-led services exports, leading to different effects for the top-line current account balance. For countries that send more tourists abroad than they receive, the impact of a shock to global travel pushes current accounts toward surplus; for countries that receive more than they send, the effect is reversed. This neatly illustrates that, if we are to use heuristic schemes to understand the performance of contemporary capitalist systems, we need to take both the imperative to earn income, and the imperative to earn forex, into account.

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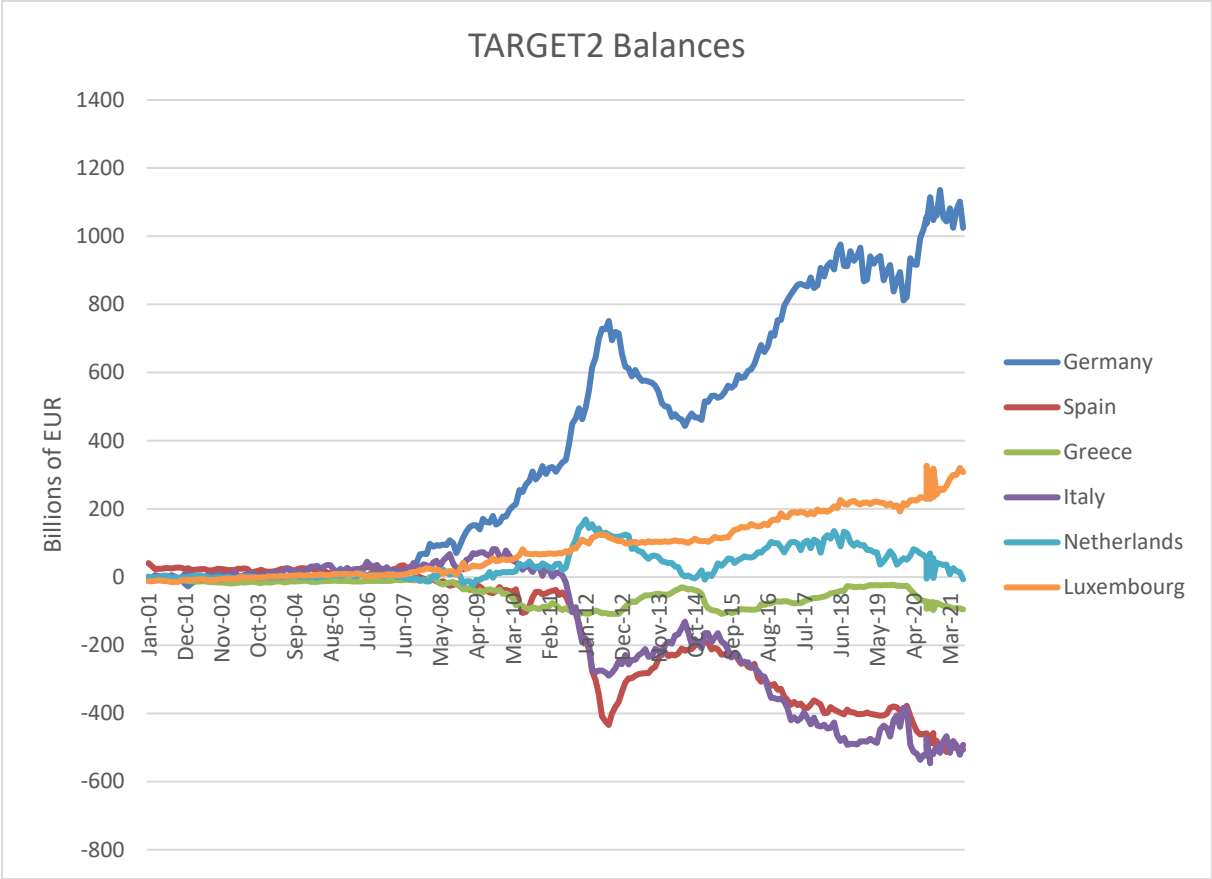


Figure 1: Source ECB