

MMT, trade and the pound

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What would happen to foreign exchange, imports and exports if the UK had a government that understood modern monetary theory?

Would money leave Britain because we import too much?

And would sterling collapse?

In this video, I explain why these fears misunderstand how international trade and currencies actually work.

Imports and exports involve real goods, services and resources, but they also create financial transactions. When a British importer exchanges pounds for another currency, the sterling does not simply disappear from the UK monetary system. Its ownership changes.

Exchange rates can change when demand for currencies changes, but international trade is only part of the story. Enormous financial flows also arise from investment, property, shares, bonds, banking and speculation. These movements can have a greater influence on sterling than Britain's trade balance.

I also explain Britain's balance of payments, the relationship between the current and financial accounts, and why a trade deficit should never be confused with a government budget deficit. The UK government's ability to create sterling is not determined by Britain's imports or exports.

Interest rates also matter. I argue that Britain's longstanding policy of attracting international capital through relatively high interest rates has benefited the City of London while imposing high costs elsewhere in the economy.

So what changes under MMT? The mechanics of foreign exchange do not need to change. Sterling can continue to float against other currencies. What changes is our understanding of the monetary system and our ability to focus policy on real resources, productive capacity, investment and economic resilience.

Rather than fearing trade deficits or believing that Britain can somehow run out of pounds, an MMT-informed government could concentrate on reducing unnecessary import dependence, increasing domestic investment and managing destabilising international financial flows.

An MMT government would not create a foreign exchange crisis. An MMT understanding would instead help us build a stronger and more resilient economy, which is precisely why we need such a government.

<https://www.youtube.com/watch?v=PRknxpgDqoY?si=KV0TZx80sEsaEiRU>

This is the audio version:

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This is the transcript:

One of the questions I'm often asked is: what happens to foreign currency trading when we have a government that understands modern monetary theory and is following its prescriptions in the UK?

What happens to money when Britain imports or exports as a result? Are we going to be in crisis if money leaves this country because we import things? What will happen to our exchange rate, and what does all this mean for the government and the Bank of England?

Those questions are asked so often I've decided it's time to make this video because the fact is that the issue is not nearly as big as people make out, but it's important nonetheless, and you need to understand it.

Exports are usually presented as good news for a country because they bring money into the country. They support the value of the country. People who want to buy British goods will, in effect, buy British sterling as a result.

The corollary is that imports are presented as bad because money supposedly leaves

the economy. We might have to buy a foreign currency as a consequence of having to import goods and services.

Donald Trump has used this argument to justify his utterly destructive trade policies, but trade isn't just about money. That is vital to understand. Trade is about exchanging real resources and real human labour and not simply about accumulating financial balances.

Any international financial transaction always has consequences that extend far beyond trade.

And trade is, I stress, also about both goods and services. We do import goods. We do import services into the UK, but when it comes to exports, we export many more services than we do goods, and our exports include university education, finance, tourism, insurance, and professional advice.

Britain's substantial goods trade deficit, deliberately created by Margaret Thatcher, who went out of her way to undermine UK manufacturing, so you know who to blame for that now, is partly offset by a services surplus. The overall trade balance must take both into account, but even then, it is not the whole story that we need to consider.

But let's consider what happens when we do both import and export.

British importers pay overseas suppliers through the banking system. Banks arrange any necessary exchange of sterling for foreign currency, but importantly, the sterling passes to another holder. It doesn't leave the country. It doesn't exit the UK. It's still here.

Sterling only exists within a banking system that is regulated by the Bank of England. It cannot exist in any other way. Remember, money is not a real thing. It is an entry in a ledger, and the only ledgers which effectively record sterling balances inside the financial services sector are those maintained by banks regulated by the Bank of England.

So if we do import, sterling is used to make a payment by buying foreign currency, but the sterling itself stays in the UK. Somebody buys it. The point is, if too many imports happen, there may be fewer buyers of the sterling than the people who want to import want to sell, and therefore the value of sterling may fall.

I repeat that, and let's be clear about this. If somebody wants to buy goods which are priced in euros, the sterling purchaser has to sell their pounds to buy euros. If too many try to do that, the value of the pound may fall against the euro.

But remember, the volumes of trade are so large, and the relative trade imbalances are so small, and they are, that the impact upon sterling as a consequence of any trade imbalance is minor. That is the key point to understand.

These transactions might change the ownership of money and the resulting financial claims, but they do not reduce them. The amount of sterling is not changed by either importing or exporting where the process works in reverse, by the way.

So how does foreign exchange work? Foreign exchange is just the process of buying and selling different currencies. Banks and currency dealers match buyers and sellers. This is a genuine market, one of the few that probably exists. And exchange rates determine how much one currency costs in terms of another. The fundamental value that is imparted to literally equate that exchange is normally the value of goods and services exchanged between the countries in question, and it's very often determined by their relative labour productivity.

But the point is that whatever happens, sterling exchanged for dollars remains within the sterling monetary system. Its new owner can spend, save, invest, or exchange whatever money it has, and that is not altered by the process of importing and exporting.

The system can change the value of the currency, but as I've already said, these movements are surprisingly small because trade deficits and surpluses are very small overall in proportion to total international financial flows in sterling.

And most importantly, when I come to that point about international financial flows, many of them are not about trade at all.

Foreign investors buy British businesses, property, shares and bonds. Banks transfer funds internationally to finance their operations. Investors move money between currencies seeking higher investment returns. Many of these transactions are entirely speculative rather than connected to production. These financial flows can, if anything, have more impact upon the value of the currency than any trade in goods and services. The answer to those is capital controls.

But what about interest rates and tax havens, because they also have an impact, and it matters? Higher interest rates in the UK can be used to attract overseas financial investment. The Bank of England has deliberately pursued this policy since the 1950s. We have had a high interest rate policy in the UK to attract into the City of London what is called 'hot money'. That is the world's mobile money, much of which is illicit, and which goes to wherever the highest interest rate is paid.

That is why the City of London has been so successful, but at cost to the rest of the UK, by imposing high interest rates on us to pay high interest rates in turn to people who live outside the UK. We are, in this sense, a perfect tax haven, and all those branch offices, as I call them, of the City of London, which have the names of Jersey, Guernsey, the Isle of Man, the British Virgin Islands, Cayman Islands, and many others, are all part of this network, which exists to maintain an artificially high value of UK currency at cost to ordinary people in this country who pay too much in rent and too much in mortgages

as a result. All of this, then, has an impact, and tax havens are used to impose a cost on us, as are high interest rates maintained by the Bank of England, and that has an impact upon our exchange rate as well.

So what does Britain's balance of payments reveal? The balance of payments records Britain's transactions with the rest of the world. The current account includes trade in goods and services, income and transfers. The financial account records transactions in financial assets and liabilities. A current account deficit has a corresponding financial counterpart, and overseas holdings of British assets are therefore important.

Britain's international financial position cannot then be understood from trade alone, and that is something that everyone has to understand. The obsession with trade when it comes to modern monetary theory is hopelessly misplaced. The whole issue is much more complex than that.

So how does all of this impact the government's money? Let's be clear. It doesn't very greatly. That's the straightforward fact. The Treasury does not receive export earnings or directly finance most private imports. The government's spending and taxation are separate from international trade payments. They are all in sterling, of course. Trade nevertheless influences employment, income, prices, and tax revenues as a consequence. But a trade deficit is not the same as a government budget deficit. And confusing the two would be a big mistake.

And, the government's capacity to create sterling is not determined by trade either. What is more, because all the government's debts are paid in sterling, the exchange rate does not impact them. Again, this has to be remembered.

So what is the role of the Bank of England in all of this? Commercial banks handle most of international payments. It is only sterling settlements between British banks that use central bank reserve accounts held with the Bank of England. And the Bank of England can create those reserves whenever required. Its ability to do so is not in any way constrained by Britain's trade balance.

However, its interest rate decisions do influence international financial flows. I've already explained this. Higher interest rates tend to attract money into the UK and support the value of the pound. Lower interest rates tend to let money leave the UK, and the value of the pound falls. But a falling value of the pound can be good for the UK economy because it encourages more employment, more economic activity, more investment, and growth. In other words, in the current system, the Bank has little overall control over exchange rates, but that which it has tends to be used in a way that is frankly not beneficial to the overall level of economic activity in this country.

So, does modern monetary theory change any of this? The answer is yes in the sense that it helps us understand the reality of what we are looking at. That is always the case. MMT changes nothing about the way in which international trade or foreign

exchange operates. Let me make that very clear. In fact, MMT says international trade and foreign exchange rates should operate as they do now, and the pound should float against other currencies to absorb the shocks that are created, for example, by war, supply shortages and so on.

Exchange rates, MMT says, should reflect real trade, real investment, and wider financial flows, and they are not just part of simply domestic monetary plumbing. In that sense, MMT changes very little about foreign trade and the stability, which overall does exist with regard to exchange rates, would not in any way be impacted by MMT.

But the ability of the Bank of England to create sterling, which MMT exposes, may have an impact because, as a consequence of that understanding, MMT might encourage a better allocation of real resources, the reduction of import dependence, and the creation of resources that reduce the risk of inflation and all of those things could help the stability of our exchange rate.

In this way, MMT influences exchange rates, not by playing with money itself, but by changing the underlying economic reality that makes the UK a stronger, less dependent, in a sense, more closed economy, which cannot therefore suffer the shocks which it is currently being exposed to, because of our failure to invest in ourselves.

The important point is that MMT explains the monetary system, but what it also does is provide the empowerment to understand how the real economy works.

So why do then exchange rates sometimes change very dramatically? Sometimes they have, and let's be clear, that is very rarely, if ever, because of a change in trading relationships. Major political crises are what create major exchange rate differences. The 2008 financial crisis resulted in money leaving the UK economy because the City of London tried to fail. As a consequence, money left. The value of the pound fell.

Brexit caused another major sterling adjustment because we were less competitive internationally. But it wasn't money that changed in value. The value of our goods and services and the relative power relationships between us and the EU changed, and there was a currency adjustment as a consequence.

Liz Truss also managed this goal in 2022, but that was because of her irresponsibility and the irresponsibility at the Bank of England by simultaneously announcing a programme of quantitative tightening, which was previously unknown in the world, and it was that double event which created the fall in the value of sterling.

These episodes demonstrate the importance of political and financial confidence. They do not in any way suggest that an MMT outlook would actually create a problem with regard to the exchange rate.

In fact, let's ask that question. Would MMT create a crisis of confidence? And the

answer is no. Why is that? It's because it better explains how the existing monetary system works, and it will help with better management of that system in the future. That should provide stability and not a crisis.

So what should governments actually worry about then with regard to foreign trade? It doesn't need to worry about trade deficits if they are matched by surpluses, for example, in invisible earnings.

They can worry about excessive holdings of funds in the UK economy because of an over-enlarged City of London, because that can create domestic financial instability if interest rate policy has to be run for that reason. That is a cause for concern and does suggest we should reduce our dependence upon financial services, and we will be a stronger, more resilient economy if we did do so.

And it does suggest, if we have a trade deficit that we should be investing in the UK economy to improve our productive capacity, as a consequence increasing employment and our economic security.

MMT would highlight all these issues, but all the benefits would be very real and strongly positive as a consequence.

That is the point of MMT. MMT helps us understand trade. It helps us understand the reason for investment and how we can fund it. And it helps us understand financial regulation and the need, for example, to put in place capital controls when we have a period of turbulent international financial flows because of hot money. And all of those things could create better economic stability, sustainability, and public well-being.

In summary, MMT will provide a better understanding of the management of all issues that are involved in foreign exchange transactions, our balance of trade, and real trade. That's its importance. That's why I think it matters, and there is no risk from an MMT-managed economy as a result.

That's what I think. What do you think? There is, of course, a poll down below. We do appreciate you taking part because we do look at those, and they do influence our thinking. Please leave your comments. Please do, if you want to subscribe to the channel. And if you would like to support our work, there is a button down below which will let you do that, and we would very much appreciate it.

Poll

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