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## Implementing a devaluation of sterling

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# ARTICLES

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## MONETARY POLICIES

### Implementing a Devaluation of Sterling

by Prof W. M. Scammell, Simon Fraser University, Vancouver

**A**mong those who write and talk about British economic problems today there are, when it comes to solutions, ultimately two schools: the devaluationists and the anti-devaluationists. I personally believe that the balance of advantage lies with devaluation. In the large literature of policy discussion there are, however, few, if any, definitions of what the policy of devaluation might mean in practice. It is too important a matter to be left undefined. This article attempts a definition.

#### **The Balance of Payments Problem**

The sixth purposive deflation in twelve years is still in progress in the British economy which has registered no significant rate of growth since 1964—in a world in which rival industrial countries are growing at rates varying from 3.4 per cent to 5.3 per cent.<sup>1</sup> It is the basic thesis of this article that the British government (or governments, since both political parties are equally implicated) must end this economic predicament swiftly if the British economy is not to be irreparably damaged, the British standard of life reduced relative to that of other Western countries and the country's political significance abroad extinguished.

The conventional wisdom of successive British governments has been simple, old-fashioned and ineffectual. It runs thus. The British economic problem is basically a balance of payments problem caused by changes in Britain's economic structure relative to its rivals. These changes stem from the war and are complicated and aggravated by the country's position as operator of an international currency. This balance of payments problem must, therefore, be tackled by traditional methods: deflation of the domestic economy relative to other leading economies or, in a growth-minded world, a checking of economic growth relative to the growth of other economies. That done, exports will prosper as competition on the home market shifts resources to the industries and products from which in foreign markets profit may still be won. Observing that in practice each new expansion has bred its fresh balance of payments crisis, its new speculative attack on sterling, its new necessity for deflationary package

deals, the authorities have refined elaborate peripheral measures to deal with secular import growth,—interest rate and monetary policies to ward off speculative attacks on the currency and most grandiose of all, an incomes policy to combat domestic price inflation. Some of these weapons are ingenious; some, such as incomes policy, are politically hazardous and possibly in the longer run unworkable; all are mere tophamper, latter-day refinements to the basic gold standard doctrine that a balance of payments deficit can always be cured by domestic deflation.

#### **Gold Standard Doctrine**

The case against the application of this orthodox gold standard doctrine to the British long-term problem has been put many times and will be repeated here only in summary. Three arguments seem to the writer to be fatal to the doctrine. First, the British economic problem is structural and there is no evidence whatever that long run adjustment of the British balance of payments disequilibrium can come from this source. Is it conceivable that the adverse merchandise trade balance which has been a structural feature of the British balance of payments since mid-nineteenth century will be replaced, through a great home-propelled export drive, by an enduring export surplus? All the evidence is to the contrary. Britain's exports, extrapolated according to its share of world trade and the rate of growth of the trade, on present indications would not do this. Export drives are a good and necessary part of a balance of payments policy but they are merely a part of it.

Secondly, domestic deflation, which is supposed to divert home demand away from exportable goods and domestic demand away from imports, which is supposed to drive thwarted industrialists foiled of sales at home, to seek them abroad, and which is supposed to winnow the industrial field of non-competitive firms, does not, on the record, do all of these things. It checks the growth of firms and industries indiscriminately and, as recent events have shown in the British motor industry, hits growth-minded exporters as hard and sometimes harder than somnolent home producers.

Thirdly, the industrial efficiency which should drive economic growth is reduced and weakened by the

<sup>1</sup> Between 1954 and 1964 the rate of growth of national income (at constant prices) was 2.6 per cent for the United Kingdom, as against 3.4 per cent for the United States and Germany, 4.9 per cent for France and 5.3 per cent for Italy.

series of hammer blows which the "stop-go" policy implies. It is no wonder that Britain's competitive position is worsened; the miracle is that there has been as much industrial investment and expansion as there has been.

This picture of an economic policy dominated by a single misapplied conception of external economic policy is as depressing as the economic stagnation it has produced. It is undeniable that the balance of payments has been, since World War II, a festering sore in the British economy. It is deniable that it should be the determinant of all else in the economic field. The present policy, if it can be called so, is that, by time-honoured gold standard devices the balance of payments should be brought to heel by a mammoth export expansion which, through the merchandise trade balance, improves the whole account. It is argued in this paper that though great and continuing improvement of the trade balance is desirable and necessary, other more purposive weapons of policy are available to achieve this end and to act on other sectors of the balance of payments. These "purposive weapons of policy" form a group to support the one measure which over the years has not been tried—namely a devaluation of sterling.

### Types of Devaluation

In advocating "devaluation" we must define our terms precisely. Devaluation, in practical terms, may mean three things

☐ a forced devaluation, what we shall call "devaluation under duress";

☐ a planned and small, say ten per cent devaluation, undertaken as it were in the hope that no one is looking and that a devaluation so small would not invoke retaliation;

☐ and a planned and "purposive devaluation" accompanied by other measures, the whole package deal implying that the measures constitute a basic change in British economic policy.

The first of these possibilities is undesirable. In the devaluing country it implies crisis and loss of control over the exchange rate and the economy. Carried out under pressure it is likely that in order to avoid a recurrence of the crisis and to snatch a temporary advantage, the reduction in the value of the currency would be too great. In the world economy the devaluation under such conditions of a major currency like sterling has dire potentialities. Its co-partner as a world currency, the dollar, would be subjected to speculative pressure, a number of other currencies would quickly devalue with sterling. A realignment of world exchange rates would be inevitable: at best the reshuffle might be orderly resulting in a new pattern compatible with growing trade as in 1949; at worst it might be a scramble for advantage carried on in a spirit of "sauve qui peut", a scramble from which Britain as the weakest participant could scarcely hope to gain. It is this type of devaluation under duress that successive British governments have,

rightly, been at pains to prevent. It is arguable, too, that unless there is a change of policy and unless they are a little more successful in dealing with the balance of payments problem it is also the type of devaluation we are most likely to see.

The second type of devaluation—a small reduction in the currency value carried out at some carefully preselected time seems at first sight to have something to recommend it. It pays lip service to the fact that, as price levels change and the years pass, some adjustment in the relative values of currencies is necessary. It is arguable that, if the devaluation is less than ten per cent it will not invoke retaliation, imperil other currencies or invoke the displeasure of the IMF. It would, therefore, yield some short-term advantage in the trade field which might be exploited in some way unspecified. The trouble with all this is that even if all is as claimed, the advantage derived is so very short-term. There will be a filip to exports, a check to imports and a temporary improvement in the balance of payments but unless the increase in exports is considerable and generates an export-driven expansion which then continues under its own momentum, there is little hope of the structural changes in the economy, the rise in productivity and the reduction of unit costs which the British economy so badly needs, being created. One very strong argument can be made against this type of devaluation: that once resorted to, it would make sterling even more liable to speculative attack than it has been in the past. It has been the fear that Britain would slip in such a devaluation that has made nervous holders of sterling withdraw their funds in the past. Once such a stratagem had been resorted to it would be impossible to convince them that there would not be a recurrence. The speculative game has been played so far in the majority belief that Britain would only devalue under duress. The discovery that there was a joker in the pack would make the play much more intense. In the years which followed such a devaluation foreign opinion would be hypersensitive to every change in the British balance of payments and would interpret every deterioration, however slight, as the signal for a fresh revision of the gold parity.

The third form, that of "purposive devaluation", is called by that name because a change in the existing exchange rate is the central measure among several economic measures which, as a group, signify a new and changed approach to British economic policy. These measures should be: a freeing of the sterling exchange rate so that it may fluctuate over a range of 5 per cent above or below parity—this range to be subject to review and possible adjustment in the light of experience; a use of interest rate policy on similar lines to the present, i.e., aimed at strengthening the balance of payments; a use of fiscal policy to encourage capital investment in the exporting industries and in the newer industries—mechanical engineering, chemicals, synthetic textiles, electronics, motor vehicles, etc.; a reduction in the

British tariff on manufactured imports; and the continuance of a search for a formal incomes policy.

Behind such measures certain broad purposes are implicit. These are: firstly, that in the present and foreseeable future state of British convertible currency reserves it is only by easing the pressure on reserves and throwing it on to the exchange rate that balance of payments deficits will be sustainable without warping the whole British economy beyond hope of recovery. Secondly, that growth in the British economy must be achieved and maintained; not grabbed for sporadically and then relinquished when its effects become apparent. Moreover, growth must be concentrated in key industries; the ideal condition being that, as in the Germany of the fifties, growth should be "export driven". If, in early years of the policy, growth produces balance of payments deficits, the weight of these must be pushed on to the exchange rate and not allowed to fall entirely on the reserves. Thirdly, severe measures must be used to curb domestic inflation, either cost or demand inflation. Finally, and if British entry to the Common Market looks like being long delayed, then British industry should be exposed by reduction of the protective tariff to a greater measure of competition.

The policy implicit in these measures is a unified policy in which each set of measures complements each other set and all contribute to the long term object of a British economy whose growth is sustained by its newest and most efficient industries in the export field.

### **Phases of New Policy**

The first necessity is that the policy should be executed from a position of strength. There must be no question of a hurried dive for the boats carried out in the gale of a speculative crisis and a balance of payments deficit. For this reason the operation must be phased.

Phase I must consist of building up the balance of payments to a condition of moderate strength. This should present no difficulty. It has been achieved already several times under the stop-go policy. It can be achieved again. There is just one contingent decision involved here; might it not be preferable in Phase I to strengthen the balance of payments not by domestic deflation but by a devaluation of small magnitude—say 10 per cent. This is a tempting choice. By this means the balance of payments would be strengthened without further weakening of the industrial economy and the world informed by inference of the change of policy. That is, however, just the trouble. The preparatory devaluation might well be recognised as such and its recognition precipitate a speculative retreat from sterling which would defeat the purpose of the preliminary devaluation. It would appear preferable to accept one more voluntary deflation as the preparatory necessity to the main policy. Apart from this there would be obvious advantage in having within the British economy at the time of

devaluation some measure of unused capacity with which the export drive might be launched. This unused capacity would be created by deflation.

When the balance of payments had been brought to a condition of surplus the time would be ripe for Phase II. This would consist of the devaluation itself—a declaration that sterling would maintain its exchange rate only within a range the centre point of which would be 10 per cent below the current parity. Within the range the rate would be allowed to float subject only to the intervention of the Exchange Equalisation Account which would seek to iron out only the more violent day to day fluctuations leaving basic depreciation or appreciation of the rate free to manifest itself within the range. This devaluation would, of course, have to be made without warning. It should be accompanied by a rise in bank rate to about the 7 per cent level. This would do something to retain short-term funds within the country. In its absence foreign holders of sterling would be tempted to remove their balances in case the rate depreciated still further within the range. It would be important in this phase to try to condition sterling balance holders to the new conditions and an important facet of such conditioning would be to induce the belief

- ☐ that the sterling exchange rate was probably going to be well up or at the top of its new range, and
- ☐ the fluctuations within the range were going to be mild.

It would be essential in this early period following Phase I to create conditions of calm and normality—hence the above emphasis on undertaking the whole operation from a condition of strength.

Phase III of the programme should begin as soon as Phase II has been completed—that is, as soon as the exchange rate has settled within its range and some idea of the extent of the devaluation can be gained. This final phase will consist of the measures designed to produce the structural changes in British industry and the steady growth of the economy which is the ultimate and main purpose of the whole exercise. Such measures will be numerous—too numerous to set out in detail in this paper—but will fall into certain clearly defined categories: general macro-economic measures aimed at controlling the economy under the new conditions, in particular at controlling inflation; industrial measures designed to alter the structure of British industry, moving resources into the new export orientated industries and removing, as far as possible, painlessly, old and contracting industries such as coal, textiles and selected consumer industries; and at least one measure in the trade field—a reduction in tariffs, possibly selective, to expose British industry to the stimulus of competition.

### **Sectors of Difficulties**

This then would be the framework of the new policy, of which devaluation would be the spearhead. Its aims are clear enough. It has, however, four aspects of

difficulty to which we must give attention: the reconciling of the policy with Britain's obligation to the IMF; the more general political implications of the policy; the special conditions created by the existence in London of sterling balances held by foreign central banks and the effect which devaluation may have upon the British price-level.

### **Confrontation with the IMF**

A devaluation of sterling to a floating rate would be contrary both to the Articles of Agreement of the IMF and to the practical working policy of the Fund with regard to exchange rates. The articles of the Fund provide<sup>2</sup> for the maintenance by member countries of par values for their currencies, and lay down somewhat amorphous conditions<sup>3</sup> under which a parity may be changed. More recently, in its 1961, Annual Report the Fund outlined, somewhat lamely, its aversion to free rates. The only argument for free rates which the Fund will tolerate is that "there may be occasional and exceptional cases where a country concludes that it cannot maintain any par value for a limited period of time or where it is extremely reluctant to take risks of a decision respecting a par value".

Even for such a country the Fund has many conditions. It clearly regards it as intolerable (a) that any of the major currencies should fall into this category or (b) that any considerable number of exchange rates should be allowed to fluctuate simultaneously. Moreover, a member of the Fund cannot, under the Articles, abandon a par value that has been approved by the Fund except by concurrently proposing to the Fund the establishment of a new par value. The measures proposed above are sharply at variance with these provisions. There is little doubt that the adoption by Britain of this new policy would mean a major confrontation with the Fund. The fact that the measures, for reasons of secrecy, would have to be taken before consulting the fund would not help matters. All in all the matter of British relations with the Fund require very discreet and careful manipulation in this period.

### **Reactions of the USA and European Powers**

There would be wider political problems than those raised by relations with the Fund. Two such problems—the reactions of the United States to the new policy and the reaction of major European powers—are important. The United States would probably be hostile to these measures. The official American view has for twenty-five years been closely identified with that of the Fund. Its hostility to fluctuating exchange rates extends even further back, to the period of competitive depreciation in the middle thirties. Moreover, its own balance of payments difficulties and the place of the dollar as major international currency with the pound make it essential for the United States to watch the pound closely and adjudge all

sterling policies in the light of their effect on the dollar. Any devaluation of the pound would be viewed by the United States with the greatest suspicion and in some circumstances rightly, for a devaluation of sterling might throw heavy pressure on the dollar. It would be disastrous, and would jeopardise the Anglo-American co-operation in the monetary field which has so painstakingly been nurtured since 1944, if a devaluation of sterling were to drive the United States government to follow with a devaluation of the dollar. The strength of the dollar at the time of devaluation of sterling should be a major consideration of the British government in deciding when to proceed with the scheme.

Western European powers might also look askance at a reduction of the Sterling parity. Britain is, and progressively will be, seeking entry to EEC. Such entry would mean for the country, by the reduction of the European tariff on its exports to the Community, a cheapening of its exports to the EEC countries. By devaluing it would lower the foreign exchange equivalent of the sterling price and have a double advantage. At the same time European exports to Britain although cheapened by the lowering of the British tariff would lose this advantage on the British market by their higher sterling price. It would be asking a lot of the Six to approve this. Among the European powers, the attitude of France would almost certainly be hostile and the use of devaluation would, despite France's own record in this respect, be used to strengthen the argument that Britain's external weakness makes it an unsuitable candidate for entry to EEC.

### **International Banking Responsibility**

The third difficulty of devaluation lies in the capital loss involved for all holders of sterling balances at the time of devaluation, both for sterling area and non-sterling area holders.

It is arguable that a country which acts as an international banker and whose currency is a known vehicle for the holding of reserves, both official and trading reserves, is in duty bound to pursue policies which are conducive to stability in the value of its currency,—certainly that it should avoid the necessity for its depositors to write down the gold value of their deposits by perhaps ten or twenty per cent at one swoop. This is in part true, but it is a main thesis of this article that it is just this international banking responsibility which inhibits new and constructive economic policies for Britain. If we believe that the international banking responsibility is sacrosanct then we are condemning Britain to sustain  $\$2.80 = \pounds 1$  as the official exchange rate at the cost of its domestic industrial efficiency and its standard of living. If we believe that Britain must break out of this dilemma (and many of its critics are quick to say this) then the only way in which it can be done is by serving notice on its external depositors that its economic policy priorities have changed. This the

<sup>2</sup> cf. Article XX Sec. 4.

<sup>3</sup> cf. Article IV Secs. 5, 6, 7, 8.

country must do. The alternative is a continuation of "stop-go" until, sooner or later, but the writer believes inevitably, it will have to devalue under duress.

What would be the impact on the Sterling Area of the planned devaluation policy? Were devaluation to take place the incidence of capital loss would be equal in gold and dollar terms<sup>4</sup> for all sterling balance holders but in a more practical sense the incidence would be more uneven. For holders using sterling as a reserve currency the loss would be conditioned principally by whether they, as sterling area countries, themselves devalued. Since such countries hold reserves in sterling because their trade lies mainly with the United Kingdom and other sterling area countries the change in sterling area purchasing power of the reserves would be conditioned by the new pattern of exchange rates which emerged after all contingent devaluations had been made. Certainly the overseas sterling area country would likely be forced into a devaluation which it did not want and which might not be entirely in its interests; certainly the purchasing power of its reserves would be reduced in dollar terms and in all countries not devaluing *pro rata* with sterling; but, for these countries, the sterling devaluation would not mean a straight percentage reduction in their reserves. The net effect is the result of several factors unknown until after the devaluation.

The problem of the sterling balances is a thorny one. To the banking mind the use of a policy which willy-nilly slashes the value of the deposits held for clients in good faith is an anathema. The city of London has a long and honourable tradition which is very real and valuable to bankers. That it is not just the empty cant of self-advertisement has been demonstrated on numerous occasions. Yet it must be remembered that if present policies continue and devaluation of sterling is forced upon Britain at some future time all these difficulties will come of themselves. Only if the rate of \$2.80 can be held in perpetuity can the sterling balance holders expect their deposits to be inviolate from devaluation.

### The British Price Level

The fourth and final "sector of difficulty" created by the policy of planned devaluation would be the problem of controlling the British price level under the stimulating initial impetus of the devaluation and the continuing influence of a floating exchange rate. The immediate effect of the devaluation would be to raise import prices. Since demand for British imports is mainly inelastic these price increases would be tolerated and passed on to the economy at large as a sharp inflationary filip in food prices and industrial costs. The ghost of 1951 is invoked by non-devaluationists to support this argument. To it we must add the further complication of the floating rate. If import prices imparted their influence to the general price level and therefore to export prices,

would not the beneficial effect of the devaluation be lost? Indeed if the rise in domestic prices were great would it not cause the balance of payments to go into deficit and the rate of exchange to depreciate within the range with further inflationary effects?

The answer to these arguments depends upon what has already been said about the timing of the devaluation. Certainly if it were undertaken at a time when the British economy were stretched and at full-capacity working, inflation would be a pressing danger, the more so if a devaluation under duress occurred during a speculative bear attack upon sterling during a boom when, by historical precedent, it is the over-taxing of the economy which prompts the fears which give rise to speculation. If, however, the devaluation were undertaken at a time when there was surplus capacity in the economy and both output and productivity in the export industries could rise in response to the higher demand for exports, then the higher import costs might be absorbed without any effect upon prices. If, as is advocated above, the initial period of devaluation is accompanied by fairly sharp cut-backs of domestic demand in the United Kingdom it would be possible to avoid the stimulus to the domestic price level.

With the assumption of a devaluation to a floating exchange rate there is a further twist to the inflation argument. Will not the government, emancipated from the fear of the impact of inflation on the balance of payments and the reserves, be more tolerant of balance of payments deficit when the rate is free and allow it to bear on the exchange rate? In Britain there is not much fear of this. The cost of living and domestic inflation have come to be political issues in Britain which neither party when in power dare ignore. The price level is a variable in which the electorate is more interested and implicated than the exchange rate or the foreign exchange reserves. Indeed, one might expect the government under the conditions of a floating exchange rate to be more vigilant to control the price level rather than less. Certainly there will be great need during Phase III of the operation to persevere with and perfect the various policy measures for the control of demand and cost inflation. The provision of an effective incomes policy will remain a *conditio sine qua non* of economic growth and stability.

The "areas of difficulty" attached to the plan have been set out and discussed above. These are the real costs of the course of action we have advocated and must be set against the benefits to be reaped. Let us also be realistic. The benefits are hoped for and hypothetical; the costs are known and certain. But also the results of continuing the present policy of "stop-go" are known. More than ten years' experience has demonstrated its ineffectuality. It is the writer's belief that in the final calculus the case for devaluation is strong and that only a supreme effort of this sort will enable Britain to break out of the confining web it has woven for itself.

<sup>4</sup> Unless the dollar was also devalued.