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Some Lessons of the British Devaluation

by George F. Ray, London

This report is meant to look not so much at the British economy but at its behaviour since the devaluation. This specific angle has been chosen as it is believed that certain lessons can be learnt, or morals drawn, of the developments which followed the devaluation of the pound sterling on 18 November 1967.

The Expectations

The expectations, at the time of devaluation, were apparently based on rather orthodox theory. It was expected that devaluation would boost exports, restrain imports, thus resulting in a favourable trade balance. Deflationary measures were taken in association with devaluation which were aimed at damping down home demand in order to make room for exports without overheating the economy; the incomes policy was reinforced for keeping wage increases and price rises within narrow limits with the purpose of retaining the competitive advantage offered by devaluation over as long a period as possible.

The best proof of the firm belief in this thread of thought was the Letter of Intent forwarded by the Chancellor of the Exchequer to the International Monetary Fund on 23 November 1967. This said that the Government's balance of payments target was an improvement of at least £ 500 mn a year, which on the (then) present prospects for world trade should mean a surplus in the second half of 1968 at an annual rate of at least £ 200 mn. Two caveats were significantly included into the same, by now historical, document: first, the Governments awareness that calculations of the effect of a change in the parity of a currency are necessarily extremely speculative; and secondly, that the Chancellor was prepared to take measures, as and when required, to free resources from domestic use on the scale necessary to secure the desired improvement.

The Government was not standing alone with this view. The OECD, in the December 1967 issue of its „Economic Outlook“ endorsed the balance of payments target of a £ 500 mn improvement, and very influential continental research bodies were

equally, or in some cases even more, optimistic. The National Institute of Economic and Social Research in London said in its Economic Review (November 1967, page 9): "... on the assumptions made about prices and elasticities and the timing of the various effects, the balance of payments should gradually move out of deficit during 1968, reaching zero by the fourth quarter, with a large surplus following (given sufficient resources left free for it) in 1969." This latter was however generally considered as distinctly over-pessimistic at the time.

It should also be said that all forecasters expected, at the time of devaluation, a considerable increase in output. This was thought to be generated by exports and by the replacement of imports; despite restrained consumption the expected rate of growth was quite respectable by British standards.

Against these original expectations the Financial Statement submitted to Parliament at Budget-time was much more cautious: the new Chancellor (Mr Jenkins) stated that "the position is expected to move from deficit into surplus during 1968 and a substantial surplus is forecasted for the first half of 1969".

The Outcome

At the time of writing final figures for the last quarter of 1968 are not yet known; apart from this, the balance of payments has indeed moved

Main Items of the British Balance of Payments
(£ mn)

	1967 year	1968			
		I	II	III	IV *
Balance of imports and exports **	-637	-291	-260	-186	-153
Invisible balance **	+233	+ 50	+111	+110	+109
Balance of current transactions **	-404	-151	-149	- 76	- 44
Balance of long-term capital **	- 86	-133	- 9	+192	- 65
Basic balance ** (incl. normal balancing item)	-430	-269	-143	+131	- 94
Basic balance (actual)	-430	-232	-117	+ 84	-110

* estimated; ** adjusted for seasonal variations.

Source: Economic Trends and National Institute Economic Review.

into the right direction after mid-year. The improvement was remarkable — but rather far from the originally expected £ 500 mn surplus.

As compared with the expectations in the Financial Statement, broadly speaking exports rose more than estimated by volume, but this was more than offset by the level of imports which was significantly higher than expected. The outcome however was not very different from the implied expectation of the Financial Statement as regards the balance.

In what follows an attempt will be made to analyse the behaviour of the main components of the balance of payments and of the gross national product (as measured from the expenditure side); the reaction to devaluation of output, prices, incomes and employment will also be briefly surveyed.

The Export Side

In 1968 the value of merchandise exports was 23 p.c. higher than in 1967 (for goods and services the rise was somewhat less: around 20 p.c.). This was a very significant rise by any standard; it also was markedly more than was expected in the Chancellor's Financial Statement. The comparability of the export figures for the two years is however somewhat blurred: the dock strikes in London and on the Merseyside at the end of 1967 affected export deliveries. Therefore some adjustment is justified; allowing for this factor the increase in the export of goods was probably around 18 p.c.

The question which naturally arises is: was devaluation working at the export side as expected — since a 18 p.c. rise was certainly unusual by past British standards. Views on this point are divided. Some consider the increase as a sign of clear success of the devaluation. Others are more cautiously arguing along different lines: world trade was expanding at the high rate of some 15 p.c. by value in 1968; on past relationships, such an expansion of world trade alone would have generated something like 9 p.c. rise in the demand for British exports; then there was the once-for-all effect of the Kennedy Round and a number of special factors—in the end the residual which could be ascribed to devaluation remains relatively modest. Both parties agree, however, that part—and perhaps a considerable part—of the effect of the devaluation is still to come in 1969. Indeed all the business tests support this view: businessmen are expecting a further significant rise in exports.

The development of export prices offers ground for some speculation as well. Unit values rose very slowly during 1968; at the end of the year they stood at some 8 p.c. above the pre-devaluation level. This apparently means that, on average, exporters added not more than some half of the

advantage obtained by devaluation to their profit. This probably goes some way towards closing the gap between the higher profit margins on the home market and the lower earnings by exporting (which has been a permanent complaint of many exporters). The other half was used for making British goods more competitive by way of quoting lower prices or in some other manner; it is known that some British companies have allocated considerable sums for strengthening their sales or servicing networks abroad, for additional public relations, and also for increasing the profit-incentive of their representatives abroad.

The Influence of Prices . . .

The two further points worth considering are: first, the part played by the price in international trade, and secondly, the effect of the deflationary policy on exports.

Evidence has been mounting which seems to prove that the role of the price as a decisive factor in international transactions has considerably diminished in the last ten years or so. Obviously price is one factor in the package of different factors leading to a decision to buy. It may be an important factor in the case of semi-manufactures for further processing, although others, such as delivery dates, may play an equally important part. But in the case of finished manufactures and especially engineering products price is almost certainly not any more the predominant factor. Various studies and inquiries conducted in Britain and elsewhere indicate that the influence of the price mechanism on trade flows in capital goods was small. Of much greater weight were such things as design, reputation, performance, delivery dates, and often credit. There are again other reasons which have a similar effect on the trade flows in consumer goods (these will be detailed below, in the section on imports). This state of affairs is probably the result of several factors, such as the increasing variety of sophisticated machinery and other products, leading to greater specialisation of production, the different capacity (and its utilisation) in the various countries, and of course the sharpening competition. But it casts doubt on the applicability of the orthodox methods of calculating elasticities based on expected price changes, assuming relationships which perhaps were valid in the past—simply because international trade seems to have been more and more affected and determined by non-price factors.

. . . and the Deflationary Policy

Another vexed question is the connection between prosperity or deflation at home and the ability to export. The background to the British deflationary policy following the devaluation is a simple one: "room had to be made" for ex-

port deliveries and therefore home demand had to be restrained. This may be operationally acceptable in overall terms but is certainly doubtful in specific cases. An inquiry conducted in the British motor industry, one of Britain's largest export earners, concluded that this industry, which is highly capital-intensive, required a high capital utilisation and a high and steady volume of demand if it were to operate profitably. As with other capital-intensive industries, the proportion of fixed costs has been growing. Sharp fluctuations lead to under-utilised capacity and cause some labour problems as well. They act as a disincentive to improvements in productivity, they lead to a decline in the rate of return of capital, and weaken the industry as an effective exporting unit. Checks on home demand can thus be seen as hampering the industry's performance overseas rather than stimulating it to greater efforts.

Constantly High Imports

While exports turned out better than expected, the case of imports was exactly the opposite. The very high arrivals in the beginning of 1968 were ascribed to the effects of the dock strike, but in actual fact imports remained just as high all the year through (although they did not rise any further). Eventually, this led to the introduction of an import deposit scheme at the end of the year; it is too early as yet to estimate the result of this new attempt which has no history at all in Britain since it has never been applied.

The actual rise of imports between 1967 and 1968 was about 6.5 p.c. This compares with an output growth of 3.75 p.c. Again, there are some special factors to be taken into account, such as abnormal increases of silver and diamond imports (probably connected with the monetary crises during 1968), the likelihood of some speculative stockbuilding, the rebuilding of stocks of liquid fuel following the de-stocking during and after the 1967 Middle East war, and so forth.

However, after whatever allowance is made a considerable unexplained excess of imports remains. The most puzzling of course is the rise in arrivals of finished and semi-finished manufactures since this was the area where devaluation was expected to have most of its effect. The clear implication is that the price elasticity of demand for imports, on average, may be considerably lower than generally believed.

The likely situation however is that—as already detailed above in the section on exports—non-price factors have become more important than expected. In the case of investment goods surveys indicate that this indeed must have been the case: certainly for machinery—an important item on the import bill—the view of industrialists was that devaluation had hardly any effect on imports of non-standard machines and equipment; because of specialised production, design, performance and other technical aspects invariably favoured imports regardless of price and hence regardless of devaluation. Standard machines alone showed signs of being influenced by devaluation and here British producers were competing with imports more successfully—but standard machines account for a relatively minor part of imports, certainly not more than 10 p.c.

The case of consumer goods of course is different. Devaluation affected their pricing; that nevertheless consumer goods continued to be imported on a fairly large scale must be explained on different grounds. Retailers are keen to offer the public a large variety—again, almost regardless of price—and the public seems to be quite prepared to pay for “something extra”. Imported consumer goods obviously fit this bill.

The field where the price-raising effects of devaluation can be reasonably expected to work is therefore limited. Furthermore, it apparently takes some time until home producers readjust themselves. Finally, there have been marked at-

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tempts for absorbing part of the devaluation by foreign suppliers who wish to retain their share in the British market. This can be proved by the development of import unit values: apart from non-ferrous metals, the prices of most semi-manufactures and of nearly all finished manufactures increased in sterling terms—but less, and in some cases very considerably less, than the whole percentage effect of devaluation.

Other External Items

Nevertheless devaluation clearly contributed to the improvement in many respects—for example to the rise of about 14 p.c. in the number of incoming tourists.

On the other hand, there are no traces of devaluation having affected markedly the flow of short-term capital. The very high bank rate—which still remained high after the reductions in March and September 1968—was believed to attract “hot money” to London. However, confidence in sterling after devaluation remained so low that the discount on forward sterling was almost permanently big enough to make short-term investment in London unattractive if covered against exchange risks.

The Internal Position

Output rose more than expected. This was the result of higher total final demand—which in turn was inflated by unexpectedly high private consumption, higher exports and higher stockbuilding. Investment, on the other hand, was lower than foreseen in the Financial Statement. This development was of course almost contrary to what the Government desired, especially as regards consumption and investment. Most of the rise of consumption was in the beginning of 1968; the public was expecting a tough budget (rightly—and it was announced three months ahead that a severe budget was to come) and anticipatory buyings took unexpected and unprecedented proportions. Stockbuilding, too, was fairly high. Since both private consumption and expenditure on stockbuilding are highly import-demanding, the upsurge of these two components of the gross national product explains a part of high imports.

The lack of livelier investment activity is the outcome of complex matters in which the time of the re-establishment of business confidence plays probably a major part. All the indicators and surveys signal now an upturn for 1969—the upturn which was expected a year earlier.

Price developments deserve some details: the consumer price index in the last quarter of 1968

was 5½ higher than a year ago. The increase was therefore rather moderate; to some extent this led to a consumer boom in the beginning of the year because between the fourth quarter of 1967 and the first quarter of 1968—i.e. the first 3-4 months following devaluation—the index rose hardly at all, which caused unexpectedly high purchasing power, in real terms, of the consumer.

Average earnings increased just under 7 p.c. in the same period—i.e. from the fourth quarter of 1967 to the same period in 1968—and on balance it is probably right to say that prices rose less and wages somewhat more than might have been predicted. The deflationary credit squeeze was also working less efficiently than was expected. (Measures were taken to remedy some of these shortcomings.)

The Government's incomes policy was aimed at keeping wage and price increases within manageable limits. A certain amount of strife and industrial unrest was however apparently unavoidable: working time lost by disputes just about doubled from 1967 to 1968.

Summing-up

Developments of the British economy during the first year following devaluation took in some respects a turn which was different from the expectations. Both exports and imports were higher than foreseen; private consumption was much livelier than expected—due to the faster rise of money incomes relative to prices than had been forecast, and to some extent also to the inefficiency of credit restrictions and to the unwillingness of consumers to stop increasing (let alone reducing) their standard of living—and the expected upturn in investment activity was delayed. The improvement in the balance of payments was much slower than originally hoped for.

This however is an interim statement. In many respects the longer-term effects of devaluation may come during 1969. Some lessons are already fairly clearly recognisable: for example, that non-price factors have become very important and upset orthodox price-elasticity estimations, that the consumer may behave in a way which is not in line with official thinking, and so on. Another moral which may possibly arise later on is that the timing of the effects of major change such as devaluation was, is quite different from any pre-conceived ideas.

It is difficult to say to what extent are all these uniquely affecting the British devaluation—or are factors to be taken into account in the case of any devaluation; the lessons are here and they are worth remembering.