

# SCHOOLS BRIEF

## A much devalued theory

Many amateur economists argue that a country with a gaping trade deficit and sluggish growth simply needs to devalue its currency. The fifth article in our series on economic fallacies explains why devaluation is not an easy remedy

WHETHER you are an American exporter selling computers in Japan, or a Briton planning a skiing holiday in France, you have good reason to care about exchange rates. But much nonsense is talked about them. One common mistake is to see possession of a strong currency as a policy goal in its own right, as if a strong currency denoted a strong economy. It is better to consider the exchange rate as an instrument rather than a goal of policy. And even that role is more limited than is commonly believed.

Many people think that devaluation is a painless way to boost exports and output, and so create jobs. At the other extreme, some economists claim that devaluation only generates inflation and is powerless to affect real economic activity. The truth lies somewhere in between. Under certain conditions, devaluation can be a useful policy tool. It is not, however, a soft option.

Economists talk about currencies being "devalued" or "revalued" when there exists some sort of fixed exchange-rate regime, such as Europe's exchange-rate mechanism or, until December 1994, the Mexican peso's link to the dollar. When, on the other hand, a free-floating currency such as the dollar falls or rises this is referred to as a "depreciation" or an "appreciation".

The exchange rate—the price of a currency in terms of others—is one of the most important prices in the economy, because it determines the relative prices of domestic and foreign goods. On the surface, a weaker currency might therefore appear to be an obvious solution to a trade deficit. A cheaper dollar, for example, makes American exports more competitive abroad and imports more expensive in the United States. It seems obvious that this should lead to more exports and fewer imports.

But will it? The theory of purchasing-power parity (PPP) says

that the prices of tradable goods should be the same in any two countries when expressed in a common currency. This implies that, in the long run, a devaluation should have no lasting impact on an economy's real exchange rate (the nominal exchange rate adjusted for differences in inflation at home and abroad) and hence no impact on trade and output.

When a country devalues, the theory predicts, its real exchange rate will move back towards its PPP, either through a rebound in the nominal rate or as a result of an equal rise in prices. Devaluation will raise the prices not only of imports but also, eventually, of domestically produced goods that compete with imports. This pushes up inflation, which will rise further still if wages then chase higher prices.

This is exactly what has happened over long periods. Chart 1 shows that over the past two decades, changes in the dollar exchange rates of the main industrial economies have been more or less offset by those countries' inflation differentials with America: countries with the biggest devaluations have had the highest rates of inflation.

In other words, changes in nominal exchange rates have had no lasting effect on the external competitiveness of individual economies. (That should not come as a surprise: if devaluation

really were a miracle cure, then Britain, whose currency has fallen almost continuously since the second world war, should now have the world's most successful economy.)

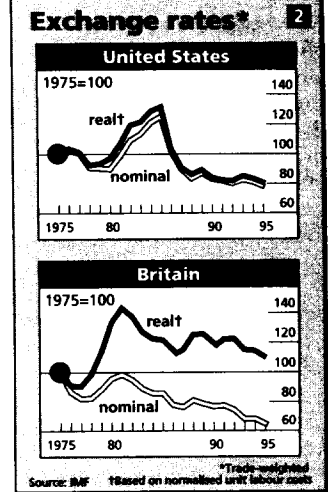
In the long run devaluation will be offset by higher prices. But how long is the long run? It is the answer to this question that will determine the effectiveness of devaluation as a tool of policy.

As Chart 2 shows, prices often take time to adjust, and the time taken differs from one economy to another. Over the past two decades movements in the nominal exchange rate of the dollar has caused large matching swings in its real exchange rate. In contrast, the depreciation of sterling over the past 20 years as a whole has failed to make British exporters more competitive: it has been wiped out by higher costs.

### Honey, I shrunk the deficit

To understand better how devaluation works, consider a country which has an unsustainable current-account deficit. It produces two types of goods—tradable and non-tradable—and assume that capital and labour are fully employed (ie, unemployment is at its natural rate, consistent with stable inflation). There are two ways to reduce that country's deficit. The first, "expenditure reduction", is to squeeze domestic demand by tightening fiscal or monetary policy. This will curb imports and so trim the trade deficit. But it will also lower the demand for home-produced, non-tradable goods, so unemployment will rise.

To achieve internal as well as external balance requires a second instrument, "expenditure switching". The price of non-tradable goods and services needs to fall relative to the price of tradables, to encourage firms to shift their production to the ex-



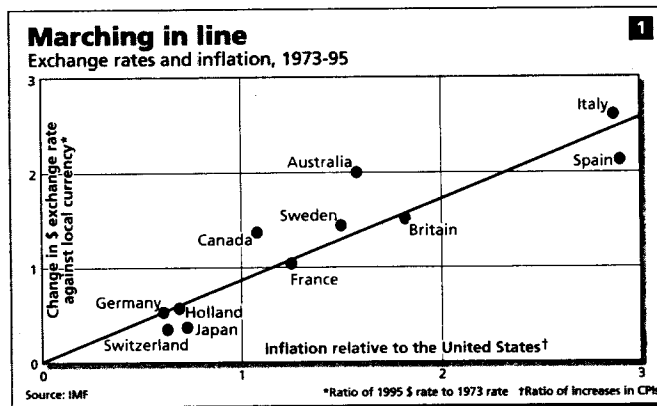
port sector. How can that shift in relative prices be achieved? High unemployment would eventually put downward pressure on wages and the prices of non-tradable goods, but it may take time. This is where devaluation may be able to speed things up. By raising the domestic price of tradables, and so making exports more profitable, it may help economies to shift production with a smaller rise in unemployment.

Note, however, that by itself devaluation will not work if, as is common in countries with widening external deficits, the economy is operating flat out. If supply cannot expand, rising prices will quickly erode the initial gain in competitiveness. Devaluation must go hand in hand with a reduction in domestic demand (through monetary and fiscal tightening) to make room for more exports.

Thus the issue of whether devaluation is a useful policy tool turns on two crucial questions.

- First, how flexible are nominal prices and wages? If they are fully flexible downwards then devaluation is unnecessary. Prices and wages will automatically decline, and so the real exchange rate will fall without a devaluation of the nominal rate.

- Second, how flexible are real wages? Devaluation works only if real wages are allowed to fall and workers do not instantly demand compensation for higher import prices. But if real wages are rigid (eg, due to comprehensive wage indexation or powerful trade unions) then devaluation will immediately generate a wage-price spiral. In such circumstances, devaluation is not only pointless, in the sense that it



cannot achieve a lower real exchange rate, it also risks creating ever-rising inflation.

In the 1970s and 1980s, in inflation-prone Latin American economies, where indexation was rife, the benefit of devaluation was often wiped out by higher inflation within a year. This is why some countries, such as Argentina, have since fixed their exchange rates, in order to break the inflation cycle.

Thus for devaluation to be both necessary and effective as a policy tool, nominal wages and prices must be "sticky" downwards, while real wages must be flexible downwards, at least for a period. If both conditions are met, devaluation can for a while reduce the real exchange rate and help to speed up the relative price changes needed for economies to adjust. However, it is nonsense to view devaluation as a painless cure. For devaluation to work, it must (a) go hand in hand with tighter fiscal or monetary policies, and (b) it must reduce real wages. A policy of devaluation that is adopted as a soft option is likely to fail.

### Snakes and ladders

Devaluation is likely to be a more potent weapon in some economies than in others. For example, devaluation tends to be less successful in reducing real exchange rates in small open economies than in large ones.

Imports account for an average of almost 30% of GDP in Western Europe, and as much as 65% in Belgium, compared with only 12% of America's GDP. In Europe, therefore, higher import prices have a much bigger impact on inflation and hence on pay demands. This explains in part why most American economists believe that devaluation is an important policy tool, whereas more Europeans are willing to fix their currencies once and for all under monetary union.

A second factor behind the different attitudes to devaluation in America and Europe is the flexibility of real wages. Over the past decade or so, real wages have fallen in the United States. In Europe, thanks to a history of wage indexation (since abandoned in most countries), centralised wage bargaining and strong trade unions, wages have tended to catch up quickly with prices.

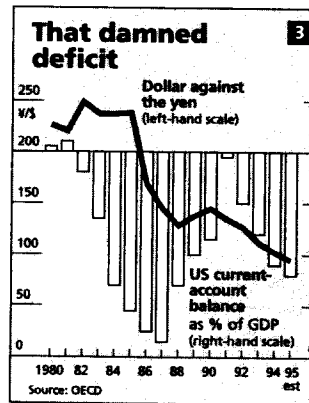
Both of these factors suggest that devaluation is likely to be less effective in Europe than in

America, and that European governments would therefore not be giving up that much under a single currency. However, recent experience in Europe might suggest that devaluation can sometimes be a powerful instrument.

Since the ERM crisis in September 1992, the Italian lira has fallen by 30% in trade-weighted terms, and sterling and the Swedish krona have dropped by about 20%. All three economies seem to have benefited: they have enjoyed faster growth than the rest of Europe, their current-account deficits have narrowed, and, contrary to past experience, inflation has stayed relatively low.

So devaluation does offer the proverbial free lunch after all? Before jumping to that conclusion, it is important to look a little more closely at the circumstances of the Italian, British and Swedish economies.

First, in 1992 these three economies had plenty of spare capacity available to be diverted into exports. As the discussion of expenditure reduction and expenditure switching demonstrated, devaluation is self-defeating in



economies already working flat out. Britain, Italy and Sweden were in deep recession when they devalued, and high unemployment helped to dampen wages. Now that there is less slack in these economies, pay demands are creeping upwards.

Second, the exchange rates of these economies fell dramatically, leaving them undervalued relative to PPP. This made the currencies attractive to investors, and so allowed interest rates to fall. To support their currencies, governments had previously

been forced to keep interest rates high to compensate investors for the risk of devaluation. With that risk removed, interest rates could fall. A small devaluation would not have had the same result. Indeed, it might well have increased the perceived risk of another devaluation and so caused investors to demand even higher interest rates than before.

A third lesson is that in all three countries devaluation was accompanied by fiscal tightening. Britain's budget deficit has been trimmed from 8% of GDP in 1993 to 5% in 1995; Sweden's has been chopped from 13% of GDP to 7%.

### Dollar dilemma

Perhaps the best illustration of the principle that currency depreciation by itself is not a failsafe cure for a trade gap is the fact that America's current-account deficit continues to loom large (see chart 3), despite a 40% drop in the dollar's trade-weighted value since 1985 and a 60% depreciation against the yen and the D-mark. Likewise, Japan still has a huge current-account surplus despite the strong yen.

One reason why America's current-account deficit refuses to disappear is that exchange-rate movements have been partly offset by relative price movements: since 1985 wholesale prices have risen by 21% in America, but fallen by 16% in Japan. The sharp appreciation of the yen has imposed severe deflation on Japan.

Furthermore, the underlying cause of America's current-account deficit—insufficient savings in relation to investment—persists. America's budget deficit (ie, government dissaving) has fallen since the 1980s, but is still high by historic standards. Meanwhile, household savings have shrunk by a third over the past decade, to only 4.5% of personal income in 1995.

When the dollar was grossly overvalued in the mid-1980s, it needed to fall somewhat to allow American producers to regain their competitiveness. But the dollar is now the wrong weapon to use to cut America's trade deficit, especially when the American economy has so little slack. The only sure way for the United States to close its trade gap is for the country to save more, by eliminating its budget deficit. A cheaper dollar is no substitute for a responsible fiscal policy.

## How cheap is a piece of string?

GOVERNMENTS and businessmen are always fretting about whether their countries' products are internationally competitive. But how should competitiveness—ie, the real exchange rate—be measured? Which index of inflation should be used to deflate the nominal exchange rate? The IMF calculates no fewer than six different measures of the real exchange rate based on: unit labour costs, "normalised" unit labour costs (ie, after adjusting for the effect of the economic cycle), consumer prices, wholesale prices, the value-added deflator in manufacturing, and export prices. They often tell different stories.

The chart shows three measures of Japanese competitiveness. Between 1980 and 1994 (the latest figures available), the yen's real exchange rate based on unit labour costs rose by 75%, that based on consumer prices by 80%. Yet relative export prices increased by only 33%. In part this is because productivity growth in Japan's traded sector has been much faster (and so cost

increases smaller) than in non-tradables. Japanese exporters have also squeezed their profit margins to maintain market share.

Which is the best gauge? Consumer prices are too broad, as they include non-tradables; export prices are too narrow as they include only goods that are actually traded—once goods become uncompetitive they disappear from the index. This leaves relative unit labour costs as probably the most reliable measure.

