Floating rates

Yes, flexible exchange rates certainly do work in practice

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The following article is in response to the paper by Walter Eltis entitled 'Do exchange rates work in practice?' (International Currency Review, May-June 1974, pages 29–32 and 42). Mr Eltis will reply, in turn, in the September–October 1974 issue.

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There has been considerable disquiet among economists recently. The world economy has probably never been in greater disarray. It faces a collection of problems which would be worrying enough taken individually, but which are of extreme gravity when taken in conjunction. This, however, is not the only reason for anxiety. There is another: the apparent collapse of traditional economic relationships, and the consequent rejection of time-honoured solutions. In the domestic economy the prime example is the breakdown of the Philips curve: higher levels of unemployment no longer seem to reduce the rate of increase of money wages. It follows, according to several authorities, that demand restraint is no answer to inflation.

In the world economy, the corresponding failure is alleged to be the unresponsiveness of trade flows and the international balance-of-payments to exchange rate movements. Despite successive revaluations of the deutschemark, West Germany's trade surplus has been larger and more robust than ever. But the United Kingdom is not significantly reducing its non-oil deficit, although it is now two years since the 9% depreciation of sterling in June–July 1972. There have been murmurs of uneasiness – and protestations of incredulity – at this situation. Some observers have even hinted that the right step for Britain would be to revalue the pound, if a sufficiently large loan could be arranged to ensure credibility in the foreign exchange market. The importance of the article 'Do flexible exchange rates work in practice?', by Walter Eltis, in the May–June 1974 issue of *International Currency Review*, is that it makes the central points explicitly and unequivocally. It crystallises doubts which many observers and foreign exchange practitioners have begun to feel. It is a good illustration of the academic economist's function of pouring theoretical acid onto the troubled waters of reality.

There is, however, some uncertainty about the issue. Mr Eltis's paper in fact looked at two questions without distinguishing between them very carefully: 'do devaluations succeed in curing a balance-of-payments deficit?' and 'do flexible exchange rates work?' These are closely related questions, but they are not identical.

In a trivial sense, flexible exchange rates always work. In the absence of central bank intervention, they clear the market. No support for a currency, to remove an excess supply, is necessary. The balance-of-payments is balanced – by the action of supply and demand. But this, clearly, is not the sense intended by proponents of flexible rates. What they mean – and what they require for the validity of their case – is that the foreign exchange market must be stable.

This more ambitious notion is the one under consideration. But the conditions needed for the stability of foreign exchange markets with completely flexible rates are, roughly speaking, the same as those which are needed for the success of a devaluation in a 'régime' of fixed, but adjustable, rates. Here is the link between the two questions.

This may appear to be a quibble, but it is not. Its significance is that no country in the last seven years has had *fully flexible exchange rates.* The authorities have retained their intervention powers, and continue to eliminate excess supply and demand when the rate they think appropriate is beneath or above that indicated by random day-to-day or month-to-month fluctuations. The volume of intervention is the counterpart to the size of balance-of-payments

	All countries	USA	UK	West Germany	France	Italy	Japan
1967	91	89	96	90	95	92	90
1968	91	91	90	88	96	92	90
1969	94	95	93	92	97	95	95
1970	100	100	100	100	100	100	100
1971	106	102	110	108	106	108	104
1972	115	105	122	119	116	115	115
1973	132	113	130	144	144	128	137

Table 1: Manufacturers' export prices in the main industrial economies, in US dollars.
Index numbers, 1970=100.
Source: *National Institute Economic Review*, NIESR, May 1974.

surpluses or deficits in a fixed exchange rate world. If all had been well in recent years, countries with depreciating currencies should have achieved smaller deficits or moved into surplus; those with appreciating currencies should have had diminished surpluses or slipped into deficit. This should be the criterion for judging the new, and less rigid, framework of international economic relations.

But Mr Eltis does not concentrate on the balance-of-payments, but rather on shares in world trade. This is misleading, for two reasons. First, the determinants of a nation's share of world trade are not the same as the determinants of the difference between its imports and exports. The extra factor is the rate at which the nation's economy is growing relative to the rate at which the world economy is growing. *A dynamic economy should have a rising share.*

Mr Eltis's delight in discovering this truism is rather ingenuous. He quotes, with approval, the results of a study by Houthakker and Magee which showed that, between 1951 and 1966, 'whenever world incomes grew by 1%, Japanese exports increased by 3·5%, West Germany's exports increased by 2·1%, US exports increased by 1% and British exports increased 0·8%'. Later, he says, 'It is . . . the countries with fast growth rates that have had the strong export performances'. This proposition is not in dispute; its drawback is that it is not very illuminating.

Why shouldn't fast growing economies have payments surpluses? The answer is that economic growth has two effects – a capacity effect and an income effect. The capacity effect increases the ability to supply exports and, left to itself, would probably create a highly favourable shift on the external account. But the income effect should counter this and keep the situation in equilibrium. It should prompt an increase in the demand for imports because, as people become better-off, they will want to consume more foreign goods, as well as more home-produced goods.

The problem has been that, since 1960 and, more particularly, since 1967, the capacity and income effects have not, in all instances, been kept in step. Contrary to a common view, however, the capacity effect has not been far ahead of the income effect. When it has been, this is usually because of delinquent policies – not because of some pervasive deficiency in the adjustment mechanism; but we shall return to this later. The important point to emerge from the study by Houthakker and Magee was that, for many years, some of the most rapidly growing economies had low import propensities. It is these, not the high export propensities, which deserve attention.

Mr Eltis's second oversimplification was to stress trade, not payments. But, of course, the balance-of-payments differs from the balance of trade, because of 'invisibles'. These are commonly neglected, but, as we shall soon see, they are crucial. Their responsiveness to devaluation is rarely perverse and is usually very rapid. For certain items, such as investment income, the gain to the balance-of-payments is, indeed, almost of a windfall character. A flow of dollars from an investment in the United States cannot help being worth more pounds, if the pound loses value in relation to the dollar.

Table 1 shows trends in the balance-of-payments of the six leading industrial economies, excluding government transactions. It includes all those components which are influenced by economic variables and is, therefore, the one that is most relevant for our purposes.

It is a myth that the response to devaluation or revaluation is not that which the textbooks would claim. This table demonstrates an almost

	United States	West Germany	Japan	France	Italy	United Kingdom
1967	8·3	2·7	0·3	1·0	1·5	0·4
1968	5·6	3·3	1·5	0·3	2·5	0·2
1969	5·3	2·4	2·6	−0·1	2·2	2·0
1970	6·9	1·6	2·7	0·9	0·9	2·7
1971	3·6	1·3	6·3	2·0	1·9	3·5
1972	−1·0	2·4	7·4	2·2	1·9	1·4
1973	8·8	5·3[1]	1·4[1]	2·5[1]	−2·5[1]	−0·3[1]

Table 2: The balance-of-payments of main industrial economies (in billions of US dollars; all transactions except those determined by governments).

[1]Estimates. The figures are all taken from 'International Financial Statistics', IMF. Although full balance-of-payments figures for 1973 have been prepared by individual countries, they have not so far been put onto an 'International Financial Statistics' basis. The estimates are, therefore, simple extrapolations from the first and second quarter figures. It seemed better to follow this procedure than to insert figures compiled on a different basis, which would have broken consistency.

Source: *International Financial Statistics*, IMF, May 1974.

universal tendency for adjustments to be in the right direction, although not always of sufficient magnitude. There is one vital and spectacular exception, but before discussing this, a review of each of the countries one by one is in order.

1 *The United Kingdom:* The British devaluation of 1967 was the first of the major parity adjustments. The response was lagged, but powerful. By 1971 the surplus was the third largest in the world. More significantly, the surplus in each of the three years, 1969, 1970 and 1971, was higher than in any previous year since the war.

2 *France:* The franc was devalued in 1969. By 1970, equilibrium had been more than restored and, in 1971 and 1972, healthy surpluses were recorded.

3 *The United States:* The dollar was devalued in 1971. As in the British case, there was a delay of about eighteen months before the benefits began to appear; but when they did it was in a big way. The US surplus in 1973 was the largest in recent years, and the turnround was of the order of $10 billion.

4 *Japan:* The first significant revaluation of the yen was in 1971. (Mr Eltis is, therefore, incorrect when he says, 'since [1967] the deutschemark and the Japanese yen have been revalued at rates of 5% to 8% per annum relative to both the dollar and the pound'). Until 1971 the surplus had risen steadily. In 1972 it increased once more, probably because of the usual lags in the adjustment process. But in 1973, the surplus dropped; and, by the end of the year, Japan was in serious payments difficulties, signalled by some speculative attacks on the yen. Prior to the oil price rises, which hit Japan particularly hard, the Ministry of International Trade and Industry in Tokyo had been forecasting a $7 billion deficit for the 1973–74 financial year. It is significant that the change was sharpest with Japan's main trading partner, the United States, and it was the alteration of the yen-dollar parity which had been the most sizeable.

5 *Italy:* Italy's policy had been to keep its exchange rate stable. For a long time this was accompanied by a succession of small favourable surpluses, but in 1973 it appeared that the exchange rate had become unrealistic – mainly because of irresponsible demand management. There had been no determined attempt to prune the government deficit until recently; and it is, therefore, difficult to reach any conclusion about the likely effect of the floating of the lira last year.

Thus it is untrue that exchange rate movements do not correct payments imbalances. They do. But what about the vital exception? What about the runaway West German surpluses of 1973 and early 1974?

Before looking at the later period, it is important to examine the situation in 1970 and 1971. In 1969, the deutschemark was revalued. In the next two years the surplus progressively declined – and, indeed, in 1971 the West German balance-of-payments was the weakest of the leading industrial economies.

This contradicts the popular view of the West German position, in which the plus sign is thought to be continually on the increase. In fact, the surplus rises and falls shortly after the deutschemark falls and rises. The popular view arises from a preoccupation with the visible items, which have obstinately remained in surplus for many years. This overlooks the vital proviso that the invisible deficit has been growing, without interruption, since 1968. The main cause of this has been the remittances to Mediterranean countries of income earned by the *Gastarbeiten*.

But the persistent trade surplus and the rising invisibles deficit are two sides of the same coin. The availability of foreign labour has been a factor in the steady growth of industrial production and, consequently, of exports. It is not the case that the growth record of the West German economy has been exceptional in recent years – contrary to Mr Eltis's assumption about the comparative dynamism of different economies. Productivity in manufacturing has increased no more rapidly than in Britain, which is typically regarded as the laggard of the industrial economies.

In 1973 output per man-hour was 19% higher in West Germany than in 1970; in Britain it was 18% higher. *The very different rates of growth are due to the different rates of labour force increase.* In Britain there has, in fact, been a small decline, while in West Germany the inflow of foreign workers has enabled firms to maintain the momentum of the 1950s and 1960s, and to compensate for a fairly indifferent productivity record.

The standard response of the West German balance-of-payments to a revalued currency in 1970 and 1971 should help to maintain a sense of proportion. But the enigma of the explosive surpluses of 1973 and 1974 remains. Despite the more expensive deutschemark, the volume of exports grew rapidly, while imports were almost static. Why was this?

The main reason was the West German Government's abstention from the worldwide panic to reflate in 1972 and 1973. Domestic monetary policy gave priority to the containment of inflation at a time when other countries were concerned about rising levels of unemployment. Signs of an incipient boom early in 1973 were quickly stifled, and domestic demand was depressed for the remainder of the year. A recent OECD report shows that export growth has been fastest where home demand has been weakest. West Germany became the bolthole for the excess demand of its trading partners.

Why do the German authorities attach so much importance to limiting inflation? Again the contribution of the *Gastarbeiten* is central. They make the labour market more fluid and more responsive to demand-and-supply pressures, than elsewhere. If an employer wants to attract labour he does not need to offer wages which are much above the market average, because a significant proportion of the labour force is mobile. There is also the obvious point that the foreign workers are the first to be laid off if a recession is imminent, enabling unemployment among German workers to remain low despite a pronounced weakness of demand. The trade-off between unemployment and inflation is highly favourable and the Bundesbank's freedom of manoeuvre is that much greater. (The same applies in Switzerland: see our Swiss franc report on pages 78–81).

The importance of the German achievement is that it demonstrates that *flexible exchange rates are no substitute for responsible demand management.* This is a salutary lesson for economies, such as the British, where the government considers reflation to be appropriate at a time when some groups of workers are receiving pay increases of over 25%.

There is a further important aspect here. The determinants of export and import volume are export and import prices. Exchange rates do matter, but they are not the only factor affecting these prices. In particular, if an economy has already reached near-capacity constraints, a depreciation of its currency is likely to be accompanied by an upward adjustment of export prices in terms of its own currency. Its goods are no more competitive on world markets than they were before.

There is no need to call on the argument of Sir Roy Harrod to explain these movements. The reasoning behind them is elementary. If a firm has spare capacity, it may be more profitable to expand sales – because the extra revenue from greater volume exceeds the extra revenue from higher prices. But when a firm has no spare capacity it may be more profitable to raise prices if demand increases – because no extra revenue is to be achieved from greater volume, but profits will be pushed up by raising prices.

The implications are crucial. If an economy devalues while internal demand pressure is strong, the result will be that exporters will raise prices by the full amount of the devaluation and there will be no benefit to export volume. Alternatively if an economy revalues while internal demand is weak, the result will be that firms will drop prices by the full amount of the revaluation; and there will be no damage to export volume. In other words, the option to push exchange rates up and down does not permit policy-makers to abandon their responsibility to keep the posture of domestic stabilisation policy balanced.

If we look at the figures for export prices of manufactures, the pertinence of these remarks is clear. Despite the numerous parity changes which have taken place, export prices of different countries have remained remarkably closely aligned. This is precisely what one would expect in a perfectly competitive market – which is what the world market in manufactured goods is.

In a perfectly competitive market buyers are, of course, highly sensitive to price. In textbook language, the elasticity of demand is infinite to the individual supplier. It therefore seems inconsistent for Mr Eltis to borrow the argument from Sir Roy Harrod that 'where a single competitor raises prices, other businesses are content to take away part of this business's market by keeping their prices unchanged' (i.e. that the elasticity of demand is high) and to express general scepticism that demand elasticities in international trade are large enough to bring about the volume changes required.

The validity of the case for floating or flexible exchange rates has not been weakened by recent events. It is important to review the evidence and to be alerted to possible deficiencies in the adjustment process. But it is also important to keep all the evidence surveyed, and not to be misled by one or two spectacular exceptions to standard behaviour. On the whole, world trade has responded to parity movements in the right way since 1967. There are reasons for thinking that it will not continue to do so – but they have more to do with politics than with economics. The significance of the West German example is that it demonstrates once again the virtues of the 'old-time religion' of sound money and honest finance. But it has to be admitted that the political pressures on a British Chancellor of the Exchequer or on a French Minister of Finance are more severe than those on the directors of the Bundesbank. The TUC can be appreciably less accommodating than the *Gastarbeiten.* ●

Continued from page 27

and multilateral settlements just mentioned. Part was attributable to its role of accountant, in that inter-member trade rose from 42 to 46 billion roubles[9]: mutual settlements rose from 43·3 to 47·4 billion roubles, and in each year 95% were reported as having been generated by trade transactions. An incidental piece of arithmetic hence shows that about 1 billion roubles of trade among members remained denominated in units other than the transferable rouble.

A notable development took place concerning the parity of that rouble when consideration was given at the 24th meeting of Comecon's Commission on Currency and Financial Problems (Budapest, May 1973) to separating the transferable rouble from its peg to the Soviet valuta rouble. A formal divorce could give IBEC that further autonomy of standing which could help to pile a Pelion of fungible oil revenues on the Ossa of member-currencies inching towards convertibility. ●

[1]As the present writer shows in *Soviet Economics* (London and New York, 1970) pages 129–131, successive postponements meant that some bonds of the 1927 issue could in principle still be outstanding.

[2]A. Lebl in *Financial Times,* 28 June 1974.

[3]R de Vries, 'Some Financial Consequences of the Higher Oil Prices' and J Burtle, 'Options Facing the Oil Deficit Countries', *International Currency Review,* May–June 1974, pages 12–22.

[4]The identity of IBEC/IIB membership with that of Comecon was resumed in January 1974 by the admission of Cuba to both banks. A further political alignment was indicated at that 37th meeting of the Council (January 1974) by receipt of congratulatory telegrams from the Democratic Republics of Korea and of Vietnam (though not from China); both have occasionally sent observers to Comecon Sessions.

[5]'Exchange and Interest Rates in IBEC,' *International Currency Review,* November–December 1973, pages 17–21.

[6]*Economic Survey of Europe in 1973,* United Nations, New York/Geneva, 1974, Ch. 2, sect. 5.

[7]*IBEC 1973,* Moscow 1974 (with statistical annexes for 1964–73).

[8]The proportions of settlements are not cited in *IBEC 1973,* but were kindly supplied in correspondence, by IBEC's Economic and Research Department (Director, H Gramer).

[9]Read off from histogram (Diagram 1, *IBEC 1973*).