Devaluing the pound won't do what its advocates want it to do [1]

Written by **Ben Southwood** [2] | Thursday 2 May 2013

Civitas this weekreleased a pamphlet [3], written by import-export businessman John Mills, arguing that the UK government should target an exchange rate a third lower than the current one, in order to boost demand and UK manufacturing by raising net exports. In turn, this would lessen the burden on the welfare state, allow the government to extricate itself from the economy, alleviate long-term unemployment, improve the self-help ethos and traditional work ethic, and even arrest the UK?s international relative decline, Mills argues.

While making this case Mills ties himself up in a few apparent contradictions (e.g. a strong pound is terrible because it is bad for purchasing power) and with no argument dismisses hundreds of years of economic consensus (with a very crude mercantilism) but I will try to distil the most coherent and convincing argument out of the monograph, in order to make the fairest possible critique.

While China has wound its exchange rate policy down, and Japan does not explicitly target the price of the Yen, Civitas founder David Green holds up Switzerland as a good example of how a country can target its exchange rate. Switzerland buys up foreign currency with newly-created money from the central bank in order to keep Swiss Francs at the desired target. While a Civitas blog post from a third author [4], Daniel Bentley, comes out against a similar money printing means of achieving a lower rate, it?s unclear what else Mills would propose, since he doesn?t suggest any mechanism at all.

In any case, the price of a pound is governed by demand and supply. Economic authorities could either cut demand or boost supply. Since the whole point of the scheme is to raise the demand for British goods by cutting their price a demand-cutting plan would have to be careful. Green thinks that investment into UK housing and gilts is ?artificially? propping up sterling, so perhaps he?d like to ban or limit these. Presuming this outrageous interference with trading freedom was legal; it?s unclear if the pound could actually be cheapened by the desired third by cutting these demands.

Still, foreigners hold about 30 per cent of gilts and foreign buyers have recently been responsible for a majority of transactions in prime London property. If previous investments could be hit as well as new activity, sterling would surely come under serious pressure. This would slash home-owning Londoners? wealth and hike the government?s borrowing costs, but it should also make UK manufactures (and services) cheaper.

However, even with this printing-free mechanism there should be inflation. Any import business will face higher prices on its imports. Presuming margins are already competitive, the entirety of the exchange rate driven cost hike should feed through into prices. Depending on demand elasticities ? the responsiveness of consumer choices to price rises in all the different affected markets (the UK currently imports about £570bn of goods, services and oil per year) this might produce some substitution in demand for these goods, along with a secular fall in demand. But it seems highly likely that this demand dip will not be enough to bring prices back to where they were ? and bear in mind if it did this would mean a big fall in consumption for the same prices.

The necessity to bluntly interfere in investment and housing decisions make the above method a very unpleasant one, and we have seen how Mills? promise that there will be no inflation (based on the dip in the pace of price rises seen after the exit from the Exchange Rate Mechanism) appears very unlikely. Of course, as suggested, the above demand-based scheme is highly distortionary aside from its philosophical issues. So the supply-based method of cheapening the pound ? money printing, and inflation ? starts to look much more attractive.

But ? aside from going against Bentley?s blog post, and Mills? promise not to create inflation ? printing has very clear problems as a means of boosting exports. If $1 buys £1 when the money supply is £100, and we print £100, we?d expect ? all things being equal, for the dollar to now buy £2. But since all things are equal, UK factories are still only churning out 100 widgets. These originally went for £1 (and hence $1), but now they will go for £2, so despite the fact the pound is cheaper, the widgets still cost $1. We get all the costs (and benefits) of inflation and none of the supposed benefits (and costs) of cheaper sterling.

Here?s where it gets interesting. Printing extra money is futile if your goal is to boost UK net exports past the very shortest of short runs. But it is by no means futile if your goal is to boost UK inflation to overcome the nominal rigidities (cash prices that won?t fall) particularly wages. UK unemployment is still well above the natural rate, even though employment recently hit an all-time record. One of the key reasons it reached the 29.75m peak is that real wages have been falling throughout the crisis.

A further bout of inflation would give the space for relative real prices to adjust to clear markets and bring the UK much closer to full employment of all resources. So while the paper is muddled and wrongheaded, I would actually support an exchange rate target as a misguided way of getting the extra demand we need [5].

Source URL: http://www.adamsmith.org/blog/economics/devaluing-the-pound-wont-do-what-its-advocates-want-it-to-do

Links:
[1] http://www.adamsmith.org/blog/economics/devaluing-the-pound-wont-do-what-its-advocates-want-it-to-do
[2] http://www.adamsmith.org/taxonomy/term/5918
[3] http://www.civitas.org.uk/press/EAexchange.html
[4] http://civitas.org.uk/newblog/2013/04/the-pound-must-fall-to-avoid-a-lost-decade-for-the-uk-economy/
[5] http://www.adamsmith.org/blog/money-banking/monetary-policy-still-has-teeth
[6] http://disqus.com/?ref_noscript
[7] http://disqus.com