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NOTE

The articles in this issue result from staff discussions of Mr. Hinshaw's article on Currency Appreciation (see this Review of June 19, 1951). The delay in publishing them is due to vacation schedules.

September 11, 1951

<u>NOTE ON MR. HINSHAW'S ARTICLE</u>
<u>ON CURRENCY APPRECIATION</u>

Albert O. Hirschman

In a recent issue of this Review, Mr. Hinshaw presented a forceful and highly interesting case against "Currency Appreciation as an Anti-Inflationary Device". At the outset of this critical note, I wish to make it clear that my comments are intended purely as points possibly possessing some general analytical interest and do not in any way lead me to favor currency appreciation. As Mr. Hinshaw points out early in the article, he does not address himself to several aspects of the whole discussion which appear crucial to me: whether appreciation, although possibly of some advantage to one country, should not be banned in the present situation because it would adversely affect a number of other countries; and whether appreciation should not be ruled out because it is likely to lead to an increase in demands for U. S. aid.

Mr. Hinshaw instead chooses to fight appreciation on the much more difficult ground of the self-interest of the appreciating country, arguing that appreciation doesn't pay -- not because retribution will be swift, but because there is no money in it in the first place. It is in attempting to buttress the case against currency appreciation in this way that Mr. Hinshaw makes a number of points which deserve some critical examination.

<u>Appreciation versus relaxation of restrictions</u>

Mr. Hinshaw's main reason for preferring relaxation of restrictions to appreciation in a situation where a country suffers from externally induced inflationary pressures, is his contention that appreciation would not reduce prices to consumers whereas a relaxation of restrictions would do so. He reasons that, in the absence of relaxation of restrictions, appreciation would merely result in monopoly profits accruing to importers since the quantity of imports would not increase. This conclusion appears to me to have been reached on the basis of rather unrealistic assumptions.

To make his point, Mr. Hinshaw must assume that restrictions hold quantities of <u>all</u> imported commodities rigidly at pre-appreciation levels so that the increased demand for imports resulting from appreciation will be entirely suppressed by the controls. The type of restrictions maintained by most countries are not, however, of so stringent and all-embracing a nature. Not only do controls generally respond to increases of pressure upon them, but imports of industrial raw materials are in most industrial countries geared to the level of economic activity while genuinely restrictive controls apply principally to manufactures and consumers' goods. In other words, even without positive action to relax existing controls, appreciation is likely to lead to larger imports.

The real alternative before countries experiencing externally induced inflationary pressure is therefore <u>whether they should increase</u>

their imports by appreciating without relaxing the current level of restrictions or by relaxing these restrictions without appreciating. 1/

From the point of view of the immediate anti-inflationary impact, an appreciation that would lower prices and increase the supply of key industrial raw materials might be more effective than a relaxation of restrictions that would primarily result in a more abundant supply of consumers' goods. The principal argument for preferring relaxation of restrictions appears to me to be the long-run gain in resource utilization which outweighs any short-run advantage.

Once this is said, one can only agree with Mr. Hinshaw that appreciation will generally not have anti-inflationary effects if it is undertaken under conditions which do not permit it to lead to its normal result, i. e. a larger availability of goods for home consumption. It is a measure of the partisanship of the ECE report that it advocates appreciation at the same time for its anti-inflationary effect and because, under present demand conditions, it is unlikely to lead to a larger import or smaller export surplus. This is remarkably crass case of wishing to have one's cake and eat it too.

On the other hand, I cannot completely agree with Mr. Hinshaw's thesis that appreciation without relaxation of restrictions would only lead to monopoly profits being amassed by importers. In order to prevent the decline in the local currency cost of imports from being passed on to consumers, importers would have to abide by a mutual agreement not to cut prices; more important, one must assume a complete absence not only of bulk buying by government agencies, but of efficient price controls that maintain some relation between costs and selling prices. These conditions are not realized for most countries where appreciation has been discussed. Thus even when appreciation does not result in more imports, it may still lead to lower prices for imported goods and could in certain specific situations, be a tactical anti-inflationary move of some usefulness. I wish to repeat, however, that whenever appreciation is not expected to lead to an increase in imports (or to a decrease in exports), the case for appreciation as an anti-inflationary move of importance is indeed decisively weakened.

1/ In fact, it is quite conceivable that with appreciation a country can achieve an increase in the volume of its imports in spite of tightening up on its import restrictions.

Appreciation and the terms of trade

Mr. Hinshaw rightly points out that "in the absence of non-symmetrical assumptions, there is no presumption that appreciation [or devaluation] would have an enduring effect on terms of trade". 1/ But this statement would provide practical guidance for any particular country only if it permitted the inference that, typically, a country cannot and should not expect much change in its terms of trade from exchange rate changes. In my opinion, this inference is not justified since any particular country is far more likely to be confronted by non-symmetrical than by symmetrical conditions affecting demand for, and supply of, its imports and exports. The nature of this asymmetry is usually known in an approximate way and must be taken into account in formulating exchange rate policy. 2/

The Parallelism of U. K. and U. S. Terms of Trade

As empirical evidence for the lack of connection between exchange rate changes and movement in the terms of trade Mr. Hinshaw

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1/ *loc. cit.*, page 8.

2/ For Mr. Hinshaw's statement to have value as policy guidance for individual countries, it would at least be necessary that, in arranging countries according to the impact of any given exchange rate change on their terms of trade, the resulting frequency distribution be approximately of the "normal" type, with the mode at the no-change-in-terms-of-trade point. But Mr. Hinshaw's argument merely proves that there is some kind of frequency distribution varying all the way from strong deterioration to strong improvement of the terms of trade. The nature of the distribution can be inferred only from knowledge about the actual supply and demand conditions affecting imports and exports of various countries. Because of a number of considerations relating to foreign trade structure, the actual distribution seems to me less likely to be normal than skewed or asymmetrically bi-modal. But even if we had no hunch whatever about the shape of the distribution it would still be illegitimate to assume a normal distribution as a working hypothesis since, at least for the social sciences, it has long been recognized that the normal distribution is a misnomer and does not occupy any privileged position.

presents an interesting chart showing the striking parallelism between the United Kingdom and the United States terms of trade from 1924 to date. The fact that the terms of trade of the two countries have moved along roughly parallel lines in spite of the many changes in the sterling dollar rate that have occurred during this period, is taken by him as evidence that exchange rate changes have no great impact on terms of trade whose course appears to be mainly affected by changes in the relationship between prices of raw materials and manufactures. Whereas the latter proposition cannot be questioned, the chart presented by Mr. Hinshaw is not inconsistent with the thesis that changes in the sterling rate have been of real weight in influencing British terms of trade.

In the first place, it should be made clear that the chart does not portray British terms of trade with the United States or the U. S. terms of trade with Britain. In order to test Mr. Hinshaw's point, two such series should be constructed, one obviously being the reciprocal of the other. Mr. Hinshaw's thesis would then be confirmed if the two series were not to exhibit any significant ups and downs after changes in the dollar-sterling rate.

Since, however, British-American trade is only a fraction of total British and total U. S. trade, the chart portrays primarily the terms of trade of Great Britain and the United States with third countries. For this reason, the chart may serve merely to bring out the fact that, whatever change in the terms of trade of one country is caused by its exchange rate move, is rapidly transmitted to the terms of trade of the other country (or that whatever changes in the terms of trade develop without exchange rate changes for one country are duplicated by the other countries through exchange rate changes).

That this interpretation of the chart is defensible, becomes clear from the following reasoning: Suppose two countries, A and B, with largely similar composition of imports and exports in the sense that both are importing primarily raw materials and exporting primarily manufactured articles. Suppose also the countries are competing with each other for their export markets. Then if country A depreciates and if this depreciation results in the deterioration of its terms of trade because, in terms of foreign currency, its export prices fall relative to the prices of its imports, country B, which does not depreciate, will presumably have to lower its export prices in order to retain its markets. Thus, B's terms of trade will deteriorate along with those of A even though it has not depreciated its currency. Therefore, any parallel movement of the terms of trade of A and B cannot be taken as proof that A's devaluation has had no effect on its terms of trade.

A similar situation prevails if we suppose that country B, as a result of increasing productivity or for other reasons, is able to lower the prices of its exports in terms of its imports, thus deteriorating its own terms of trade without currency depreciation. If country A's export prices are sticky then one way of maintaining its foreign markets would be currency depreciation. Here again the terms of trade of both countries would, after a short tendency to diverge, eventually move along parallel lines; but, once more, this parallelism would offer no proof for the thesis that currency appreciation did not affect the terms of trade of the depreciating country. In fact, the hypothetical case just discussed appears to fit remarkably well the movement of the U. S. and British terms of trade as shown in the chart for the period from early 1949 to 1950.

September 11, 1951

FURTHER OBSERVATIONS ON APPRECIATION

Randall Hinshaw

In reading Mr. Hirschman's interesting comments, I find that there is much with which I agree, and I am grateful to him for providing this opportunity to restate my position.

At the outset, I wish to make it clear that it was not my intention in my paper to demonstrate that currency appreciation is never of any value as an anti-inflationary technique. On the contrary, it has seemed to me abundantly clear that where the inflationary process is the result of a persistent external surplus (i.e., excess of receipts over payments of foreign exchange), appreciation may be a highly effective weapon against inflation, even in cases where substantial direct restrictions remain on trade and payments. I argued, and still believe, that where there are comprehensive restrictions on payments, the removal of such restrictions is likely to be a more effective procedure than appreciation unaccompanied by liberalization, but I did not intend to imply that appreciation in such cases is of no value in dealing with inflation.

The countries for which currency appreciation has recently been recommended fall into two sharply defined groups: (1) countries, such as Ceylon, in which the inflationary process is largely the result of a marked increase in external demand accompanied by a sharp increase in export prices and incomes and by the emergence or expansion of an external surplus, and (2) countries which are not characterized by an external surplus and in which the inflationary process, while in some cases set off by external factors, such as a rise in import prices, is basically generated and maintained by domestic inflationary policies.

In the first type of situation, a good case can be made for appreciation, even in the absence of liberalization. The major issues with respect to currency appreciation, however, arise in the case of countries which are not characterized by an external surplus and whose major interest in appreciation is to take effective action against rising import prices. 1/ It was with this latter case for appreciation that my paper was primarily concerned.

In reviewing this case again, I would like to point out in the first place that a rise in the import price level is not in itself inflationary; indeed, if the demand for import goods is inelastic, the effect

1/ Concern over rising import prices, notably of primary products, is the major reason advanced by the staff of the Economic Commission for Europe for its recent proposal to appreciate Western European currencies. Economic Survey of Europe in 1950, Geneva, 1951, Chapter 5.

on the price level of home goods may be deflationary. Nevertheless, rising import prices may set off an inflationary process, either by creating budgetary difficulties, which may lead to inflationary methods of public finance, or by inducing a wage-price spiral. Consequently, concern over rising import prices is fully warranted, but it is difficult to see how appreciation would materially improve the situation unless it were feasible to permit an increase in the volume of imports.

Unless the volume of imports were permitted to rise, the act of currency appreciation would not in itself insure a decline in the retail price level of imports. Conceivably, there might be some initial competitive price cutting, but if the supply of imports were not permitted to increase, this could mean only the emptying of retailers' shelves and either the emergence of queues or a return to equilibrium prices. If price ceilings and consumer rationing of imports were in effect, or if the government were the importer, the retail prices of imported goods could be lowered by state action, but this would mean that consumers, in view of their inability to expand purchases of the imported items, would have more funds than before with which to bid for other goods. Thus, the lower prices of imports would tend to be offset by higher prices in the uncontrolled sectors of the economy.

Mr. Hirschman is of course right in maintaining that, with the exception of cases where direct controls on payments are rigid and all-embracing, appreciation would automatically result in an increase in the volume of imports, even if there were no relaxation of restrictions. The question cannot be left here, however, since it is necessary to know whether the country which contemplates appreciation (or, for that matter, relaxation of restrictions) under such conditions can <u>afford</u> the increase in imports. Any increase in the volume of imports would involve a corresponding -- or possibly greater than corresponding -- increase in foreign-exchange outlay, entirely regardless of the average price elasticity of demand as expressed in local currency. 1/ Consequently, in order to avoid a loss of exchange reserves following appreciation, it would not be sufficient for foreign-exchange proceeds merely to refrain from falling; they would have to rise by as much as the increase in foreign-exchange outlay. Thus the highly probable effect of appreciation, as Mr. Hirschman recognizes, would be a deterioration in the balance of payments.

1/ That is to say, the price level of imports expressed in <u>foreign currency</u> (<u>e.g.</u>, dollars) would either remain unchanged or tend to <u>rise</u> following appreciation, so that any increase in the quantity of imports would inevitably mean at least a proportionate -- or possibly more than proportionate -- increase in foreign-exchange expenditure.

Of course if a country can afford a deterioration in its balance of payments, either by dipping into its reserves or by obtaining grants or loans from abroad, the effect would be anti-inflationary and in all essential respects the same as the effect achieved by reducing or removing an external surplus. On this point, Mr. Hirschman and I are in complete agreement. In general, however, the countries here under consideration (notably the continental Western European countries) are characterized by severely inadequate reserves and, consequently, in the absence of additional assistance from abroad, would probably be forced not only to prevent, by direct means, the increase in the volume of imports which would otherwise accompany appreciation but, in addition, to cut back the volume of imports to correspond to the reduction in foreign-exchange earnings which would be expected under normal demand and supply assumptions. Under such conditions, the retail price level of imports, instead of falling as a consequence of appreciation, would actually tend to rise.

The latter part of Mr. Hirschman's note is concerned with my discussion of the effect of currency appreciation on terms of trade. Much of what he says in this connection I wholly agree with, and most of such differences of opinion as may exist are differences of emphasis rather than of substance. I think I am less confident than Mr. Hirschman in the ability of an individual country to predict the lasting effect of appreciation on its terms of trade, but I did not intend to deny that certain countries are in a position to influence their terms of trade in some degree by changing the external value of their currencies. I merely maintained that the extent to which most countries can produce an enduring effect of this kind by such action has often been seriously exaggerated -- a proposition with which Mr. Hirschman appears to agree.

The chart showing the striking parallelism between British and American terms of trade during the past three decades was not intended to prove that British terms of trade are not affected by changes in the dollar sterling rate. Instead, it was offered in evidence of two other propositions: (1) that changes in the dollar-sterling rate are less important than other influences in affecting British and American terms of trade; and (2) that changes in the dollar-sterling rate cannot be depended upon to affect British terms of trade in a consistent and readily predictable way. These generalizations I still believe to be valid.

In conclusion, Mr. Hirschman presents an ingenious theory which is designed to account for the established parallelism between British and American terms of trade and to show that this parallelism is consistent with the proposition that British terms of trade may be substantially influenced by changes in the dollar-sterling rate. While Mr. Hirschman is correct in maintaining that this parallelism is logically consistent with the latter proposition, his theory would appear to shed little light on the apparent lack of any consistent historical pattern in the behavior of

British terms of trade following changes in the dollar price of sterling.

One final point: In the case of an individual country, the demonstration of a probable improvement in terms of trade following appreciation is not in itself sufficient to clinch the case for appreciation as an anti-inflationary measure. As I indicated in my paper, the maximum improvement in terms of trade would be approached at an exchange rate at which exports were close to zero, with imports kept close to zero by direct controls. Even under less extreme assumptions, any improvement in terms of trade which is obtained at the cost of a reduction in the volume of imports would tend to be accompanied by an increase in the retail price level of imports (or, alternatively, by smaller rations). Under such conditions, appreciation might augment rather than diminish the danger of spiral inflation, in spite of the improved terms of trade.