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BRITAIN'S BALANCE OF PAYMENTS PROBLEM
AND
THE STERLING DEVALUATION

by

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Last 19 November, on a Sunday morning, millions of newspaper readers throughout the United States discovered they could not understand the first-page headlines:

"British Slice Pound, Cut Credit, Ask Loan"

"British Devalue Pound To \$2.40 To Avert A New Economic Crisis; Other Restrictions Are Imposed"

Undoubtedly, most of us quickly turned to the familiar world of the sports pages. But in the ensuing days and weeks a stream of headlines and news stories about devaluation, balance of payments, and gold speculation only added to the mystery and confusion:

"Gold-Buying Wave Swells, Battering Dollar in Europe"

"Demand for Gold Slips in London"

"Price Cut for Scotch Doubtled; Distillers Add 11.5 Percent on Exports"

"Britain Shows Her Worst Trade Deficit in History as Gap in Payments Widens"

"U.S. Gold Drops by \$475 Million"

"U.S. and 6 Nations Vow to Keep Gold at \$35 an Ounce"

"Johnson Acts on Dollar: Curbs Investing Abroad and Asks Cut in Tourism"

"Britain to Close Far East Bases; Won't Buy F-111's"

The purpose of this article is to go behind these fascinating headlines. We shall try to understand the dimensions of the British balance of payments problem, why devaluation became necessary, and some of the implications of the sterling crisis for Britain and other countries. Answers to the following questions will occupy most of our attention:

What is a balance of payments? What does the British balance of payments look like?

What has been the basic deficit in the British balance of payments since 1953? How is it related to the British economy?

What is the liquidity deficit? Why is confidence in the pound sterling so important?

What has happened to the official reserves of Great Britain? What are reserves for anyhow?

What is devaluation supposed to do? How?

Is this devaluation enough to pull Britain out of its chronic payments deficit?

What are the implications of the British balance of payments crisis for the United States?

Let us now turn to their consideration.

The British Balance of Payments in 1966

The balance of payments of a nation is an accounting statement that shows the outcome of all transactions between domestic and foreign residents. Domestic residents comprise individuals living permanently in the country, all Government agencies of the country whether they are located at home or abroad, and all business enterprises and other private organizations located in the country (but not their foreign branches or subsidiaries).

Transactions are entered in the balance of payments as *debit* items when they generate payments to foreigners and as *credit* items when they generate receipts from foreigners. Depending on one's analytical purpose, international transactions may be grouped in different ways. Customarily, they are classified into current, long-term capital, and monetary (short-term capital and gold) accounts. Figure 1 illustrates this form of presentation.

The net balance on goods and services. Item I shows the net debit or credit balances arising out of the sales and purchases of goods and services by British residents in transactions with the rest of the world. The net debit balance on merchandise trade (visible trade in British parlance) indicates that Britain imported £152 million more of merchandise than it exported in 1966.¹ By far the biggest net earner of foreign exchange for Britain in 1966 was dividends and interest on overseas investment. Despite the large inflow of foreign capital (particularly American) into Britain over the past decade, this country remains a net foreign investor.

The Government account generated the largest debit balance as a result of

Britain's military presence abroad. This item includes foreign military expenditures, military receipts from foreign governments, diplomatic expenses, and other transactions in goods and services between the U. K. Government and overseas residents.² Because of its size and negative nature, some people in Britain have argued for major cutbacks in British military obligations abroad.

The positive net balance on goods and services reveals that Britain sold £185 million more goods and services to foreign residents than it bought from them. In this specific sense Britain was not consuming more than its current international income in 1966. However, as we shall see, this net surplus was too small to finance Britain's net transfers and long-term investment abroad.

The net balance on transfers.

Transfers comprise the value of goods, services, and financial assets (including money) that are received from foreigners or given to them without a *quid pro quo*. Private transfers include private gifts, the transfer of assets by migrants, legacies, and so on. Government transfers include grants to overseas countries, contributions to international organizations, and similar receipts by the U.K. Government. Like the United States, Great Britain has a foreign aid program (mainly directed towards its colonies and nonindustrial members of the Commonwealth) that is responsible for a sizable debit entry.³

The net balance on current account. The sum of the net balances on goods, services, and transfers is the net balance on current account (called the income account by the British). In 1966 Britain sold or gave away (transferred) £59 million more of goods, services, and other assets than it bought or received as gifts. Hence it experienced a net debit or import balance on

current account of modest proportions. Taking transfers into account, Britain was not quite paying its way internationally in 1966.

The net balance on long-term capital. The long-term capital account includes investments and loans with a maturity (explicit or implicit) of more than 1 year that British residents have made abroad during the year, and conversely. In 1966 Britain was a substantial net investor on long-term account. Undoubtedly, private British residents would have invested more abroad if they were not largely restricted to investment in the sterling area. Government long-term capital includes intergovernment loans (primarily for economic development) and any capital subscriptions to international organizations such as the IMF and IDA.

The basic deficit or surplus.

The sum of the net balance on current and long-term capital accounts is the *basic deficit or surplus* in the balance of payments. In 1966 the United Kingdom ran a basic deficit of £175 million. The basic deficit shows how much more the country bought, gave away, or invested on long-term than it sold, received free, or borrowed on long-term in transactions with foreign residents. Conceptually, the net basic balance may be viewed as a measure of the "fundamental" disequilibrium in the balance of payments. A sustained basic surplus strengthens the international solvency of the nation, while a sustained deficit weakens it. The basic balance also measures the degree of adjustment that the economy must make in order to restore fundamental equilibrium.

The monetary account: financing the basic balance. Britain's basic deficit in 1966 was financed in

Fig. 1 – The Balance of Payments of the United Kingdom in 1966
(millions of pounds sterling)

		NET DEBIT (-) OR CREDIT (+)
I. Goods and Services		
(a) Trade balance (f.o.b.)		-152
(b) Transportation		+ 46
(c) Investment income		+371
(d) Government		-278
(e) Other		+198
Net balance on goods and services:		+185
II. Transfers		
(a) Private		- 62
(b) Government		-182
Net balance on transfers:		- 244
Net balance on current account (I+II):		- 59
III. Long-term Capital		
(a) Private		- 35
(b) Government		- 81
Net balance on long-term capital:		-116
Basic deficit (-) or surplus (+) (I+II+III)		-175
IV. Monetary Account		
(a) Official reserves: gold		+116
(b) Official reserves:		
convertible currencies		+166
(c) Sterling liabilities (net)		+135
(d) Liabilities in foreign currency (net)		-148
(e) Other		- 93
Net balance on monetary account:		+176
Net errors and omissions:		- 1

Source: Adapted from data in International Monetary Fund, *International Financial Statistics*, November 1967.

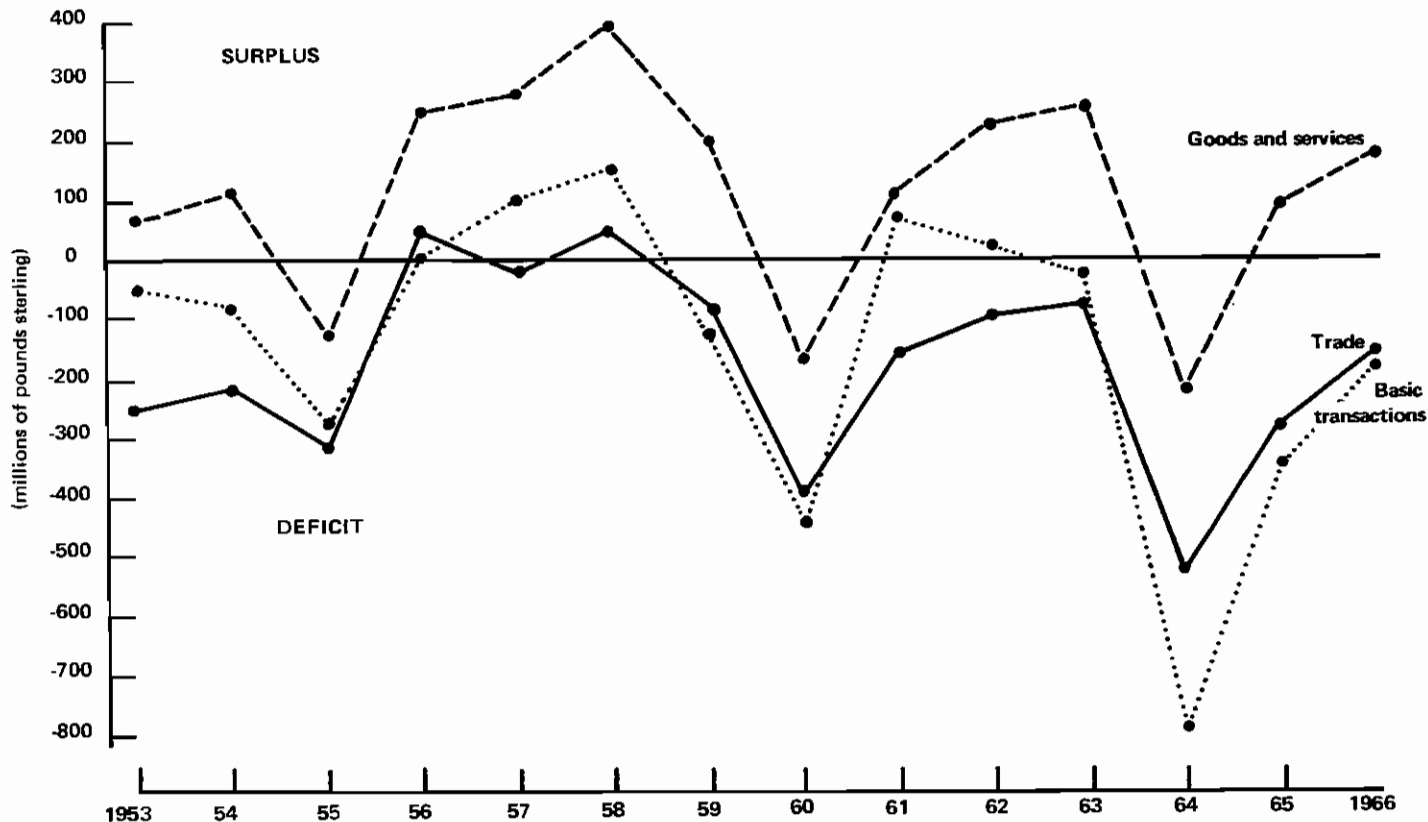


Fig. 2 – United Kingdom Net Balances on Trade, Goods and Services, and Basic Transactions, 1953-66

Source: Derived from data in International Monetary Fund, *International Financial Statistics*, January 1964 and December 1967.

one way or another; otherwise it would not have come into existence. The monetary (short-term capital and gold) account shows how this financing came about.

Let us look first at the net change in Britain's liquid liabilities (time and demand deposits, trade credits, bank loans, money market credit instruments, government short-term securities) owing to foreign residents. Net sterling liabilities to residents (including central banks) of countries that belong to the sterling area increased by £135 million in 1966 and thereby helped finance the basic deficit to that extent.⁴ At the same time, net liquid liabilities to foreign residents outside the sterling area *decreased* by £148 million. That is to say, these residents transferred funds out of Britain and thereby imposed a financing burden on Britain in addition to the basic deficit. Similarly, "other" short-term capital also left Britain in the net amount of £93 million. Altogether, therefore, shifts in liquid liabilities (both private and official) and "other" short-term capital movements (private) gave rise to a *net outflow* of short-term capital of £106 million in 1966. (We shall have more to say about short-term capital flows when we discuss the liquidity balance.)

The net outflow of short-term capital added to the deficit that the British monetary authorities had to finance out of official reserves in order to maintain the exchange value of the pound. Foreign exchange reserves (convertible currencies) were used to finance £166 million of the "official" deficit, and gold exports financed the rest. This underlines the function of international reserves as to the source of the residual financing necessary to compensate for a net deficit on other items in the balance of payments.

The net errors and omissions entry. Conceptually, the balance of payments is a double entry accounting statement. Thus, total debits must *always* equal total credits. In practice, incomplete or incorrect information about certain transactions (mainly of a short-term capital nature) and various leads and lags in payments prevents a neat arithmetical equality. Thus, any difference is accounted for by a net errors and omissions entry. Ordinarily, this entry is substantially bigger than the £1 million recorded in 1966. Substantial fluctuations in this entry from one year to the next mainly reflect speculative short-term capital movements that are comparatively difficult to trace.

The Basic Balance Since 1953

Now that we have some understanding of what a balance of payments is, we turn to an analysis of the basic and liquidity balances in the U.K. balance of payments over the past 15 years. This analysis will demonstrate that the November devaluation was the consequence of a deep-seated maladjustment of the British economy in its relations with the rest of the world.⁵

Figure 2 shows the net balances on merchandise trade; on goods and services; and on goods, services, transfers, and long-term capital for the years 1953-1966. As we have seen, this last net balance is the basic deficit or surplus.

Cyclical variations in the trade balance. The trade balance exhibits a cyclical pattern of growing instability. Low points were registered in 1955, 1960, and 1964. Recovery after the 1955 low transformed the trade deficit into a small surplus in 1956 and 1958. (The modest dip in 1957 is probably attributable to the Suez crisis.) Deterioration occurred in 1959, and the 1960 low was below the 1955 low. Further-

more, recovery in the early 1960's never produced a trade surplus. A new decline led to a low in 1964 that was much below the preceding lows. Although recovery was marked in the next 2 years, a sharp deterioration in the third quarter of 1967 (not shown in figure 2) finally forced devaluation on Great Britain.

The cyclical behavior of the trade balance has imposed a similar pattern on the goods and services balance. This is not surprising when we note that merchandise trade is about twice the *absolute* value of all service trade. The goods and service balance has remained in surplus with the exception of the 3 trade low years. During this period the service balance (not shown in figure 2) has shown no tendency to rise or fall, unlike the trade balance. In 1953 the service balance was £320 million and in 1966, £337 million.⁶ Despite a comparative overall stability, the individual components of the service balance have undergone marked shifts. In particular, a rising credit balance on investment account has been neutralized by a growing debit on Government account.

It follows that fluctuations in the trade balance have also exerted a dominant influence on the behavior of the basic balance. The largest basic deficits all correspond with the largest trade deficits in 1955, 1960, and 1964. Observe that the basic balance has been in *deficit* 9 out of 14 years and that the surpluses in 1956-58 and 1961-62 were modest compared to the deficits. Although variations in the basic balance are mainly attributable to shifts in the trade balance, the steady expansion of net outward transfers has added to the absolute size of the deficit, especially in the 1960's. After staying considerably below £100 million in the 1950's, net outward transfers jumped to £111 million in

1961 and reached £244 million in 1966. Most of this rise is traceable to an expansion of Government foreign aid. Long-term capital outflows show no definite trend (private outflows are subject to Government restriction), but in the 1960's they also have worsened the basic deficit. The high net outflow in 1964 (£374 million) exacerbated a situation that was already poor because of the big trade deficit.

This brief review of the net balances making up the basic balance in the British balance of payments since 1953 leads to these conclusions: (1) The trade balance exhibits explosive cyclical variations with a downward trend in the trade deficit over the period. (2) Shifts in the trade balance have been the dominant cause of shifts in the goods and services balance and the basic balance. (3) Over the period the generally positive balance on goods and services has been too small to finance net outward transfers and net long-term capital outflows. The cumulative basic deficit for 1953-66 was £1,896 million.

The Stop and Go Economy.

Although the trade balance is not the whole explanation of Britain's balance of payments problem, it is clearly the key factor. Why has this balance experienced such violent cyclical swings? By and large, these shifts in the trade balance have been induced by changes in the pace of activity within the British economy.

A simple explanation of the relationship between changes in domestic economic activity and changes in the trade balance runs along these lines. When the economy goes into an upswing, higher production stimulates higher imports of inputs (raw materials, fuels, machinery, et cetera), and higher factor incomes generate more imports of consumption goods.

This expansion phase does not induce an equilibrating rise in exports because exports (unlike imports) depend mainly on economic conditions abroad. Indeed, by pushing up the prices of British export goods (through both a demand-pull and cost-push inflation) expansion may restrain any rise in exports. Furthermore, export goods may be diverted to booming domestic markets which offer manufacturers easier sales than do foreign markets. For all these reasons, a rapid growth in the British economy causes a worsening of the trade balance which, if severe enough, creates a basic deficit in the balance of payments.⁷

Conversely, a slowdown in the British economy induces a slowdown (at times, an absolute decline) in imports of production and consumption goods. A slackening of domestic activity may also facilitate exports by stabilizing export prices and creating excess production capacity.⁸

To one degree or another, this linkage between the rate of domestic activity and the trade balance is present in all market economies. However, the sensitivity of imports to changes in domestic economic conditions appears to be much higher for Great Britain than for other major industrial economies. Figure 3 portrays this stop-go syndrome in graphic terms by comparing changes in the direction of the general industrial production index in Britain against changes in the direction of the trade balance.

The quick response of the trade balance (especially imports) to the rate of domestic economic activity has confronted successive British Governments with a cruel dilemma. On the one hand, British officials have tried to follow monetary and fiscal policies that would improve the poor growth record of the British economy.⁹ On the other hand, they have tried to strengthen a

generally weak balance of payments. Unfortunately, these national objectives have proven incompatible. Government leaders of both parties have failed to strike a sustainable balance between growth and payments equilibrium; priority has been given to one and then to the other. The result has been a stop-go economy that has pleased no one. By striving to achieve simultaneously both objectives, Britain has achieved only a sad record of slow growth and balance of payments deficit.

The Official Transactions (Liquidity) Balance Since 1953

Although the basic balance is the best indicator of the fundamental maladjustment of the British economy to the world economy, it is a measure of international solvency rather than international liquidity. In particular, massive movements of private interest-arbitrage and speculative short-term capital can make the liquidity deficit (the official transactions deficit that must be financed by the British monetary authorities) much larger or smaller than the basic deficit in any given year. As a major international financial and monetary center, the United Kingdom is very much exposed to sizable outward and inward net movements of private short-term capital that show up as shifts in its external liquid liabilities.¹⁰

Private short-term capital movements. Individuals and private institutions (mainly foreigners because British residents are subject to restrictions) may move funds into and out of Britain in response to interest rate differentials or in response to speculative fears or hopes.

When interest rates are high in London compared to (say) New York, then dollars flow to London, and con-

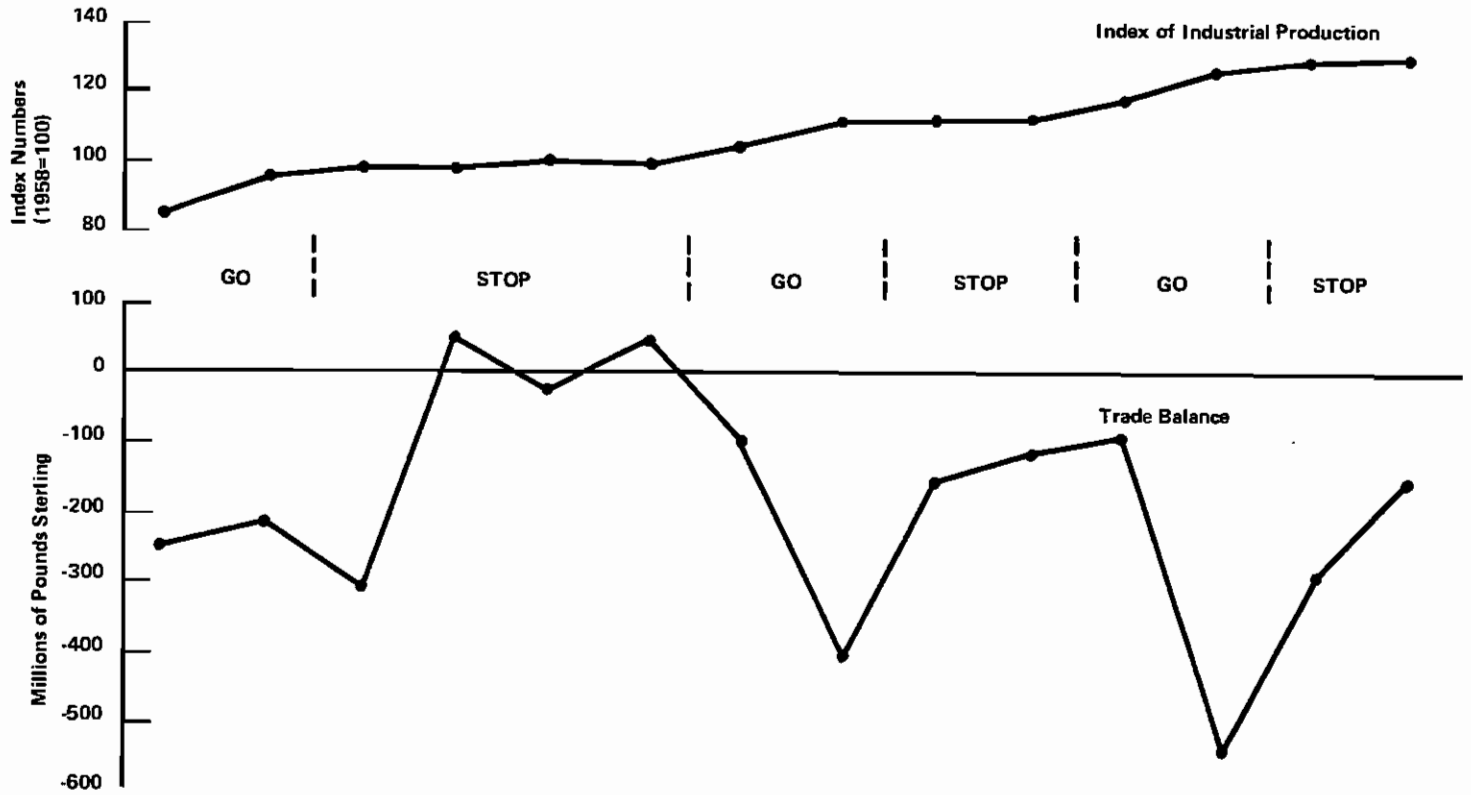


Fig. 3 – Economic Activity and the Trade Balance in the United Kingdom—The Stop-Go Syndrome, 1953-66

Sources: International Monetary Fund, *International Financial Statistics*, January 1964 and December 1967; United Nations, *Monthly Bulletin of Statistics*, various issues.

versely. Ordinarily, these funds are not speculative because they are protected against the exchange risk through the sale of forward exchange (interest arbitrage). When the Bank of England raises its discount rate during a payments crisis, it is hoping to attract interest-arbitrage capital and thereby reduce the liquidity deficit.

Private holders may also move funds into and out of Britain because of hopes of gain or fears of loss. In particular, short-term capital has left Britain in response to fears of devaluation or payments restrictions, and it has entered Britain in response to such fears elsewhere. This capital flight is bred by a failure of confidence in a currency, and by its very nature it generates a further loss of confidence. It is essentially the same phenomenon as a run on a bank. While interest-arbitrage capital is equilibrating, flight or speculative capital usually makes the liquidity deficit bigger than the basic deficit because speculators tend to go short on a currency, especially a currency like sterling that is widely viewed as weak. Bearish speculation has forced British devaluations both in 1949 and last November.

The liquidity and basic balances compared. When the net balance on *private* short-term capital flows and the net balance on errors and omissions are added to the net basic balance, the result is the liquidity or official transactions balance. The net liquidity balance *must* be financed by the British monetary authorities in order to maintain the existing exchange rate. When it is a deficit, then the authorities must dip into reserves of gold and foreign exchange and/or borrow from the International Monetary Fund (IMF) and foreign monetary authorities such as the Federal Reserve System of the United States. When the liquidity balance is in surplus, then the British

monetary authorities are able to replenish reserves and/or repay credits owing the IMF or foreign monetary authorities.

Figure 4 compares the basic and liquidity balances of the British balance of payments over the period 1953-66. Observe that the liquidity balance has usually diverged considerably from the basic balance, evidence of substantial net movements of private short-term capital. The basic deficit in 1955 was somewhat reduced by a modest inflow of short-term capital, but in 1957 the Suez crisis sparked a big outflow of short-term capital that caused a liquidity crisis despite the surplus on basic transactions. Restored confidence in the pound reversed this outflow in 1958 to give Britain a very large liquidity surplus. In 1959 the basic and liquidity deficits were almost the same, but in 1960 a drastic worsening in the basic balance was concealed by a massive capital inflow (in large measure a speculative movement of dollars responding to weakness in the U.S. balance of payments) that caused a liquidity surplus. Exactly the opposite state of affairs occurred the following year: a major improvement in the basic balance was neutralized by a big outflow of capital that resulted in a payments crisis. In 1962 a reversal of this outflow generated a sizable liquidity surplus at a time when the basic balance was becoming less favorable. In 1963 an outflow of capital intensified the basic deficit, but in 1964 a capital inflow moderated somewhat the huge basic deficit and also accompanied an improvement in the basic balance in 1965. In 1966 a large capital outflow caused a liquidity deficit much greater than the basic deficit.

The high volatility of short-term capital flows reflects the sudden shifts that have occurred in expectations

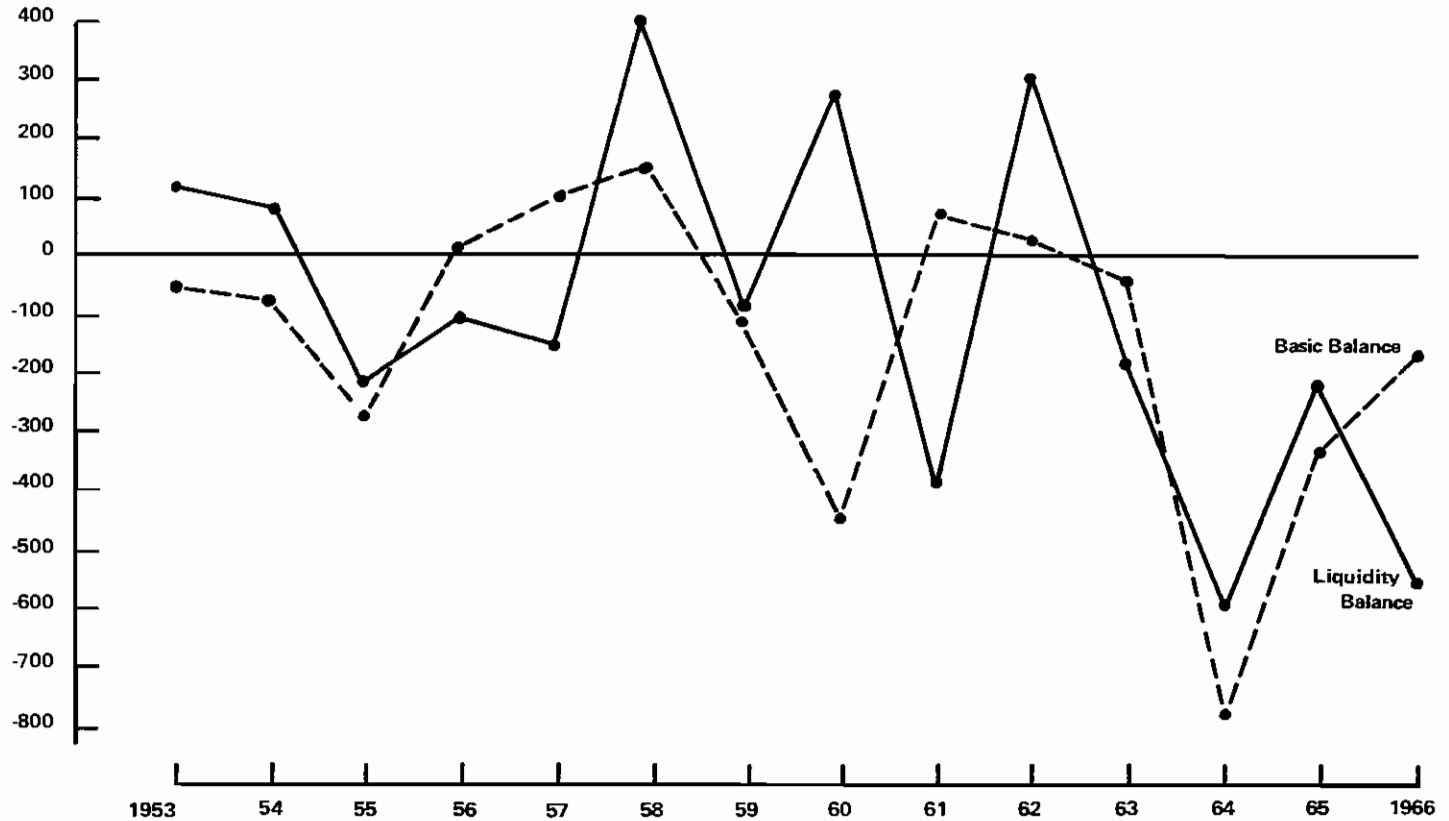


Fig. 4 — Basic and Official Transactions Balances in the British Balance of Payments, 1953-66

about the pound. At times, these expectations have coincided with an actual worsening of the basic balance; at other times, they have run counter to developments in the basic balance. During the period 1953-60, a net capital *inflow* transformed a cumulative basic *deficit* of £666 million into a cumulative liquidity *surplus* of £364 million. In the period 1961-66, however, a net *outflow* of capital made the liquidity deficit (£1,583 million) larger than the basic deficit (£1,230 million). Clearly, the pound commanded less confidence in the 1960's. The major basic deficits in 1960 and 1964 persuaded many holders of sterling that the pound was in deep trouble, turning them into bears. This deterioration in confidence intensified the pressures on the British official reserves, already dangerously low because of the chronic weakness in the basic balance.

The British Reserve Position

In the 1960's British official reserves of gold and foreign exchange have been too small to inspire confidence in the ability of the authorities to finance erratic swings in the liquidity deficit. In 1961, for example, reserves were only £1.3 billion in the face of a liquidity deficit of £387 million. Since Britain must maintain about £1 billion in reserves to avoid a collapse of the sterling area, the amount of reserves available for the defense of the pound has been almost nil. As a consequence, each sizable liquidity deficit has provoked a payments crisis with its accompanying loss of confidence in sterling. Britain was then forced to: (a) borrow heavily from the IMF and foreign central banks in order to finance the deficit, and (b) take emergency measures — sharply raising the discount rate, cutting down on domestic investment and other expenditures,

imposing a tariff surcharge, et cetera — in order to eliminate the deficit.

The function of reserves. The primary function of official reserves is quite simply to enable the monetary authorities to maintain the external value of the domestic currency. A secondary function is to provide time for fundamental adjustment to wipe out a payments deficit, if that should prove necessary.

Before the recent devaluation, the British authorities were committed to maintain the value of sterling between \$2.78 and \$2.82.¹¹ Stabilization was accomplished through the use of reserves to compensate for any gap between the demand and supply of sterling in the foreign exchange market over the support range. Figure 5 illustrates how stabilization works.

Assume the autonomous demand for sterling is D-D and the autonomous supply is S-S.¹² In the absence of official compensatory action, the price of sterling would be (say) \$2.75 where the amount of sterling demanded equals the amount of sterling supplied in the foreign exchange market. To prevent this decline, the British authorities must buy enough sterling at \$2.78 in exchange for dollars and other convertible currencies to eliminate the excess amount of sterling supplied the market at \$2.78. This excess (M-N) is the liquidity deficit that must be financed by the authorities. In effect, the authorities must shift D-D to D'-D' so that the amount demanded equals the amount supplied at \$2.78. If the authorities do not have enough foreign exchange, they must get it by selling gold or by borrowing from the IMF and foreign central banks.¹³

When a nation has abundant reserves, it is able to sustain the exchange value of its currency over a lengthy period of time while it undertakes

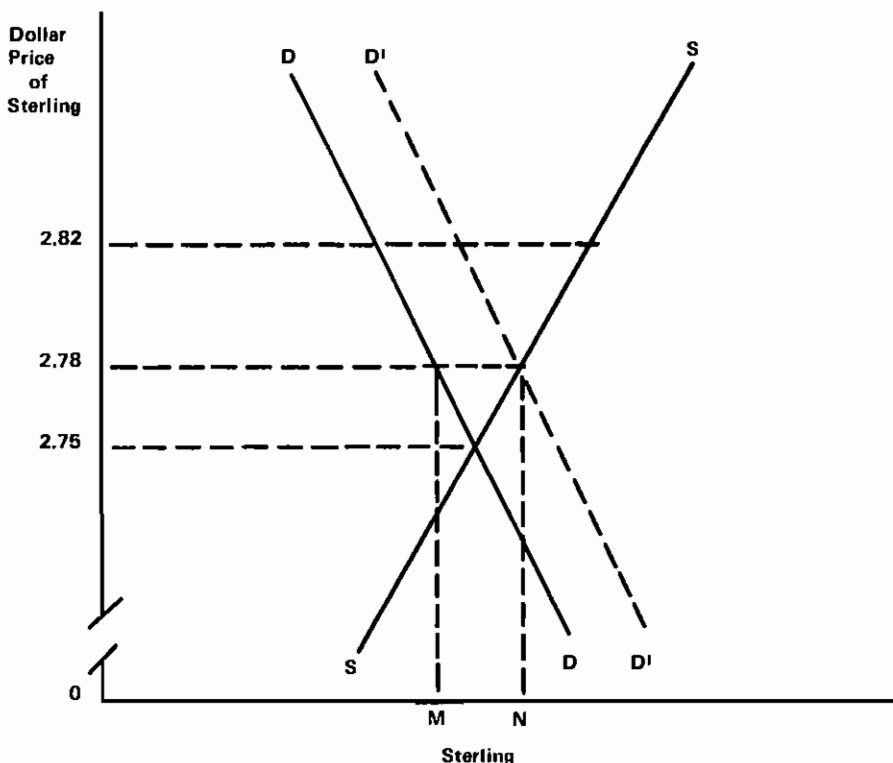


Fig. 5 – Official Compensation to Prevent a Fall in Sterling Below \$2.78

measures to eliminate the deficit. As we have observed, a lack of reserves has forced Britain into remedial actions of an emergency kind at a heavy cost in terms of internal stability and economic growth. When a nation runs out of reserves (including the availability of foreign credits) or they approach an unacceptably low level, then the authorities must either: (a) devalue the currency, or (b) impose exchange controls that restrict all private payments to foreigners and thereby render the currency inconvertible.

The decline in British reserves.

Figure 6 indicates the dollar value of British reserves and official liabilities at the end of 1960 and June 1967. During the period holdings of gold fell more than a third and the IMF gold

tranche was entirely used up.¹⁴ Although Britain increased its holdings of convertible currencies, these are actually borrowed reserves as is evidenced by the increase in liabilities owing central monetary institutions in non-sterling countries.

The other items in Figure 6 are liabilities rather than assets. They reveal the remarkable extent of British borrowing to replenish reserves. The liabilities to central monetary institutions are of two different kinds, serving different functions. The net liabilities to monetary authorities in sterling countries derive from the monetary reserve function that Britain performs for the sterling area.¹⁵ These liabilities serve as the international reserves of countries belonging to the sterling area. Shifts in them over time

Fig. 6 — British Official Reserves, Net Liabilities to Central Monetary Institutions, and Net Fund Drawings at the End of 1960 and June 1967 (millions of U.S. dollars)

	End of 1960	End of June 1967	Net Increase or Decrease
A. Official Reserves:			
1. Gold	2,801	1,780	-1,021
2. IMF gold tranche position	488	-----	- 488
3. Convertible currencies	430	1,054	+ 624
Total reserves	3,719	2,834	- 885
B. Net Liabilities to Central Monetary Institutions:			
1. In sterling countries	5,681	4,844	- 837
2. In nonsterling countries	636	1,381	+ 745
All countries	6,317	6,225	- 92
C. Net IMF Drawings			
	---	1,863	+1,863
Net Owned Reserve Position	3,083	-410	-3,493

Note: The net owned reserve position equals A-(B2 + C).

Source: International Monetary Fund, *International Financial Statistics*, November 1967.

are mainly the result of the net payments balances of these countries with Britain and with the outside world.¹⁶

The net liabilities to the monetary authorities of nonsterling countries are an entirely different matter. They represent foreign central bank assistance to build up British reserves. This assistance is mostly short term, repayable in a matter of months. The net IMF drawings serve the same function. Normally, drawings are repayable in 3 to 5 years.

It is evident that the deterioration of the British reserve position is far greater than indicated by changes in official reserves. Reserves have been replenished through massive international credits that Britain must repay in the near future. At the end of 1960, British *net* owned reserves were \$3,083 million; at the end of June 1967 they

were a negative \$410 million, a deterioration of \$3,493 million. By the latter date, Britain's reserve position had become truly desperate. It was so low that Britain could not reasonably expect to ride out another payments crisis, on a fresh injection of international credits. When the crisis came in November, British officials soon learned they had only two options: devaluation of the pound, or stringent controls that would turn back the clock to the early 1950's.

Devaluation and Its Aftermath

On Saturday, last 18 November, James Callaghan, then U.K. Chancellor of the Exchequer, issued a statement which began as follows:

The Government have decided that, in order to achieve a substantial surplus on the balance of payments con-

sistent with economic growth and full employment, the exchange rate of the pound sterling should be lowered . . . from \$2.80 to the pound to \$2.40 to the pound, a change of 14.3 percent.

Thus came the second devaluation for Great Britain since the end of World War II.

The immediate events forcing the British Government to devalue the pound have been copiously reported in the press. Here we offer only a brief review of the situation in the month preceding devaluation.

On 12 October the Government announced that the September trade deficit was the worst in 15 months. Immediately, volatile short-term capital started leaving the country. In the next few days the pound fell to its lowest support level (\$2.7825). To stem the capital outflow, the Bank of England on 19 October raised its bank rate from 5.5 percent to 6 percent. This action failed to moderate a growing distrust in the stability of the pound. On 9 November the Bank hiked its rate to 6.5 percent. Again to no avail. (Both rate increases were small because of a fear of recession at home — another example of Britain's dilemma.) All this time, official reserves were melting away despite enormous assistance from foreign monetary authorities (especially the United States).

On Friday, 10 November, Prime Minister Wilson decided devaluation was unavoidable. On 12 November the Governor of the Bank of England went to Basel to get a \$1 billion credit from the Bank of International Settlements. Instead he got a credit of only \$250 million and this carried a gold guarantee. On Tuesday, 14 November, the October trade figures revealed a deficit that was the worst since January 1964. During the rest of the week, while the U.K. Government consulted with other governments, rumors of impending de-

valuation flew thick and fast, intensifying speculative pressures on the pound. Finally, on Saturday, Chancellor Callaghan issued his statement.

This was the situation shortly before devaluation. But the many years of basic and liquidity deficits, the steady erosion of reserves, and the frustrations of the stop-go economy were the true actors in the devaluation drama.

How devaluation works. Devaluation is intended to eliminate a basic deficit by raising the domestic price of imports and, simultaneously, lowering the foreign exchange price of exports. Higher prices discourage imports in favor of domestic goods, while lower prices encourage export sales to foreigners. Hence, imports fall, exports rise, and the trade deficit gets smaller or turns into a surplus.

The key to the effectiveness of devaluation lies in the responsiveness of foreign exchange receipts (supply) and foreign exchange expenditures (demand). Consider Figures 7 and 8.

In both figures there is the same liquidity deficit at the \$2.80 rate (A-B=C-D). Now sterling is devalued to \$2.40. In Figure 7 the demand and supply of sterling in the foreign exchange market is very responsive (foreigners demand a lot more sterling to pay for more goods bought from Britain; a lot less sterling is supplied by British residents because they now buy less from foreigners), and the deficit is wiped out at the new rate (the autonomous amounts of sterling demanded and supplied become equal). In Figure 8, however, the demand and supply of sterling is much less responsive. Hence a liquidity deficit (E-F) persists at the \$2.40 rate, although it has become somewhat smaller. A devaluation to \$1.80 would be needed to remove all of the deficit.

If the actual situation of the pound sterling resembles Figure 7, then the

recent devaluation has a good chance of success. If, on the other hand, the situation is closer to Figure 8, then devaluation cannot do the job alone.

Is devaluation enough? *The Economist* makes the following estimate of the probable effects of the sterling devaluation.¹⁷ First, the average foreign exchange price of British exports will not fall 14.3 per-

cent for a number of reasons: (1) higher sterling costs of imported raw materials will raise sterling export prices by 3-4 percent; (2) the abolition of the previous rebate on indirect taxes to exporters will add close to 2 percent to the sterling cost of exports; (3) cessation of rebates under the Selective Employment Act will increase costs about 0.5 percent; (4) the corporation tax will be raised by 2.5

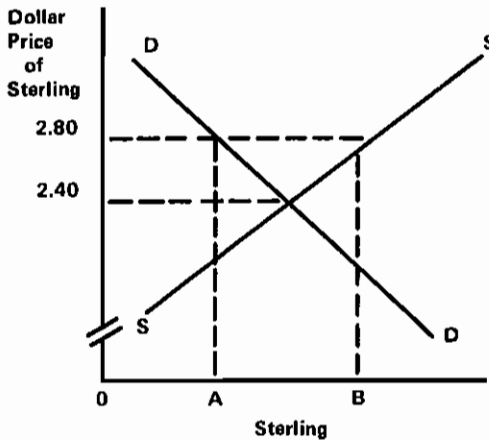


Fig. 7 – Elastic (Responsive) Supply and Demand of Sterling

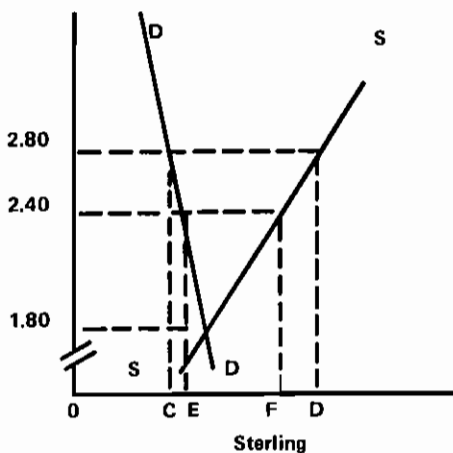


Fig. 8 – Inelastic (Unresponsive) Supply and Demand of Sterling

percent (to 42.5 percent) in the next budget. Thus the average gain for exporters will be around 7.5 percent instead of 14.3 percent.

According to *The Economist*, past experience suggests that each 1 percent fall in export prices leads to somewhat less than a 2 percent rise in export volume. Hence, export volume may eventually increase to 10-15 percent. It is further estimated that sterling import prices will go up 10-12 percent (after a time lag) and thereby lower the volume of imports by 5-6 percent. A rise in export volume of 10 percent and a fall in import volume of 5 percent should bring about a basic improvement in the balance of payments of about £500 million a year. (This is the U.K. Government's objective.) Given a "normal" deficit of about £200 million in recent years, such an improvement would generate a surplus of £300 million on basic transactions.

This transformation of the basic deficit into a basic surplus will take time. Resources, labor, and capital must be moved into import-competing and export industries. In other words, the British economy must be restructured to achieve a permanently higher level of export performance. Real improvement in the basic balance cannot be expected until the second half of this year. Indeed, the deficit may actually worsen during the first half because of the adverse terms of trade (higher import prices, lower export prices) resulting from devaluation.

The need for austerity. The estimated £500 million improvement in the basic balance assumes no further rise in the British price level. In light of the past, this assumption is a weak one. During the 1960's Britain has experienced more inflation than other major industrial countries. In 1966, wholesale prices rose 3 percent



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despite a compulsory wage freeze in the last 6 months. By August 1967 prices had risen almost another 1 percent. The effectiveness of devaluation hinges, therefore, on the Government's success in restraining increases in wages and prices. In other words, a policy of deflation and austerity.

Some Concluding Thoughts

Our analysis of Britain's balance of payments problem illuminates the formidable dimensions of recovery. Britain must transform a chronic basic deficit into a surplus that will renew confidence in sterling. Until confidence is restored, speculative capital movements will continue to provoke erratic swings in the liquidity deficit. A basic surplus is also needed to finance the repayment of huge international credits (easily exceeding \$3 billion) and rebuild monetary reserves. Only when reserves become adequate can Britain respond to liquidity deficits (which occur in the balance of payments of all nations from time to time) in a way that does not sacrifice economic growth at home.

A new permanently higher level of merchandise exports relative to imports is the key to a fundamental adjustment of Britain to the world economy. This will demand a structural re-orientation of the British economy towards world markets. The long-term solution is not lower imports. Imports must surely rise if the British economy is to resume a satisfactory rate of growth. Thus, higher exports are also the key to higher growth.

The consequences of the sterling devaluation have already extended far beyond Britain. Devaluation immedi-

ately caused a loss of confidence in the dollar that assumed the form of immense private purchases of gold in London and elsewhere. (Maintenance of the price of gold at \$35 an ounce in the face of this speculative demand cost the United States alone more than \$900 million in gold losses in November and December.) Although this speculative fever subsided in January, it can suddenly flare up again if future events precipitate another confidence crisis.

The major U.S. response to the new forces unleashed by the sterling devaluation (complicating an already severe U.S. balance of payments problem) is the mandatory cutback in private investment abroad and a proposed limitation on tourism that were announced at the start of this year.

Another consequence of the British payments problem is the decision taken by the British Government to pull out of its Far East and Persian Gulf bases by 1972. The implications of this decision for U.S. defense policy are only now being assessed.

If the British fail to cure the pound's weakness in the next few years, the consequences will be great indeed. Another devaluation of the pound would probably provoke a wave of devaluations throughout the world, breeding confusion and doubt. Another November crisis could topple the international monetary system built, as it is, on trust and confidence in the stability of the dollar. It is now more important than ever, therefore, that the United States fortify the dollar by solving its own payments problem.

FOOTNOTES

1. This is the net trade balance when both exports and imports are valued f.o.b. at the domestic and foreign points of export, respectively. Actually, British customs values imports at the point of importation (c.i.f.). The c.i.f. trade debit is bigger than the f.o.b. trade debit mainly because of transportation costs.
2. Britain, Great Britain, and the United Kingdom all refer to the same country in this article.
3. As in the case of the United States, the bulk of British aid finances British exports. Hence the net impact of aid on the balance of payments is much less than the debit aid entry.
4. In addition to the United Kingdom, the sterling area comprises members of the Commonwealth (excluding Canada), British possessions and trust territories, Iceland, the Irish Republic, Jordan, Kuwait, and Libya. These countries maintain all or part of their official reserves in the form of sterling.
5. The precise timing was due to a liquidity crisis, but this was only a symptom of the fundamental maladjustment.
6. The highest service balance during the period was £383 million in 1965; the lowest, £201 million in 1955.
7. The decisive role of import shifts in the big trade deficit years is shown by the trade figures. In 1955 imports rose £397 million while exports rose only £288 million; in 1960 the figures were £499 million and £211 million, respectively; and in 1964, £639 and £184 millions.
8. The "normal" growth in exports, together with a small decline or slowdown in imports, can quickly improve the trade balance. In 1956 imports dropped £62 million, while exports rose £304 million; in 1961 imports fell £96 million, while exports rose £159 million; in 1965 imports rose £177 million, but exports rose £430 million. All of these years were periods of slowdown in the economy, particularly in 1956 and 1961.
9. Between 1958 and 1966 real gross national product grew by only 17.7 percent in Britain compared to 44.5 percent in the United States and somewhat higher percentages in Germany and France.
10. Items IV (c), (d), and (e) in figure 1. These items also include changes in *official* liabilities, that is, net borrowings of the British monetary authorities. To obtain the liquidity balance it is necessary to separate private liabilities from official liabilities.
11. The par value of sterling was \$2.80. As a member of the IMF, Britain is obligated to maintain the exchange value of its currency within 1 percent of its par value.
12. *Autonomous* demand and supply is independent of any *compensatory* demand and supply originating with the monetary authorities.
13. If the autonomous demand and supply of sterling would push sterling above \$2.82, then the British authorities would gain reserves by selling sterling for foreign currencies (convertible into gold via the dollar). In that event there would be a liquidity surplus equal to the excess of sterling demanded over the amount supplied at \$2.82. Actually, sterling has stayed well below this rate throughout the 1960's.
14. The gold tranche is equal to a member's gold subscription to the IMF; it is \$609.8 million for the United Kingdom. The gold tranche position is a member's quota (four times the size of its gold tranche) minus the Fund's holdings of its currency. It shows the amount of foreign exchange that can be freely borrowed from the Fund. Britain exhausted its gold tranche position in 1964.
15. This is similar to the reserve function that the United States performs for the free world as a whole.
16. These liabilities drop when the sterling area countries use their reserves to finance liquidity deficits with Britain or outside countries. In the latter instance, however, the decline in liabilities is matched by an equal decline in British official reserves since foreign exchange is needed to finance outside deficits. Britain's liquidity problem in the 1960's has been compounded by the tendency of the rest of the sterling area to run a deficit with outside countries.
17. *The Economist*, 25 November-1 December 1967, p. 870-71.

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