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Strategic Devaluation, Trade and Political Convenience

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The economies of developed countries have, since 2007, experienced the most significant and persistent period of economic malaise since the 1930s. Domestic economic policies have failed to revive sustained economic growth and, as a result, unemployment remains at levels that voters find difficult to accept. In addition, without tax revenue–enhancing growth, government deficits persist, and borrowing to finance the cumulative deficits has become increasingly difficult for some countries. With domestic policies largely exhausted, but economic growth elusive, policy makers have been considering external policies as a means to stimulate their economies. Trade protectionism and strategic devaluation are potential policies. The lessons of the 1930s regarding the dangers of *beggar thy neighbour protectionism* appear to retain their currency with policy makers, but the same may not be true for strategic devaluation. The article outlines the likely poor efficacy of strategic devaluation as a politically convenient mechanism to escape the current economic malaise.

Keywords: cooperative solution, Great Depression, retaliation, strategic devaluation, trade

Introduction

> This can be seen starkly by comparing Britain and Spain. Based on debts, deficits and inflation, Britain should be the riskier credit. But British bonds yield around 2.3% whereas Spain's yield around 5.5%. One reason is that Britain can still devalue to boost growth; Spain can't.
>
> *The Economist*
> November 5, 2011, p. 96

> Meanwhile debtor governments are saying that is it is beyond their endurance to wait any longer for a problematic rise in prices; while bankers declare that, unless some sort of agreed policy is reached about exchanges, we shall soon be launched, with disastrous confusion, on a competitive depreciation of currencies.
>
> John Maynard Keynes
> *The Daily Mail,* June 20, 1933[1]

In the flurry of international, European Union and Eurozone-17 meetings in the fall of 2011 meant to deal with the sovereign debt difficulties of a number of European countries that use the euro as their currency, and indeed whether the euro would survive at all, there was a subtle undertone that a potential solution for hard-pressed governments lay in abandoning the euro so that they could engage in competitive devaluation of their *new* currencies. These events had a considerable *deja vu* feel to them. When Keynes was writing in *The Daily Mail* in the summer of 1933, the major international conference in London that was meant to find a coordinated solution to the financial stresses of what had yet to be termed the *Great Depression* had just ended in failure. The global economy had suffered three years of economic decline and governments were desperate to find a path back to economic growth – in Keynes' terms a *rise in prices*. A cooperative solution could not be found in London in the summer of 1933 and a cooperative solution proved just as elusive in the autumn of 2011. In the background lurks the non-cooperative solution of strategic devaluations.

Economic Policy and Recession

Although in many ways the global economy of 2011 is very different from the global economy of 1933, the problems are strikingly similar. The economic downturns both followed the bursting of a financial bubble. In 1930 the economic orthodoxy for domestic economic policy suggested that governments simply had to wait until markets automatically cleared via price declines. After three years of widespread and large scale unemployment, however, this price adjustment process

was taking far longer than anticipated and few believed that prosperity was *just around the corner*.[2] The economic orthodoxy of the time was also that governments should always balance their budgets and, as tax their revenues fell, they attempted to achieve the balanced budget goals by either cutting expenditures or raising new taxes. Cutting expenditures or raising taxes, of course, reduces demand, thereby exacerbating the shortfall in demand and contributing to the downward economic cycle. Under this economic paradigm there are few domestic economic levers to pull. Central banks can ensure that there is no liquidity constraint on borrowing, but the financial position and prospects are so poor for many businesses that it would be imprudent for banks to lend to them even if there is no shortage of funds available to lend. Economic growth is what is needed.

As a result of the failure of economic growth to return in the 1930s, a new economic orthodoxy arose. Of course, this was the Keynesian revolution that resulted from the attack on the ruling economic paradigm found in Keynes' 1936 book titled The General Theory of Employment, Interest and Money. Keynes correctly understood that waiting for automatic market adjustments through price declines was likely to be a slow process at best and one that imposed unnecessary hardship in terms of unemployment. It was also too slow to be politically acceptable for voters. The radical solution put forth was that restoring economic growth would require intervention to stimulate demand. Given that neither consumers, either because they were unemployed or because they were worried about losing their jobs, nor businesses with excess capacity and faced with sluggish or falling sales would increase their expenditures to stimulate demand, it fell to governments to intervene to enhance demand by increasing their expenditures. This would be accomplished by running deficits financed through borrowing until the required economic growth occurred. While a great deal has been done since 1936 in the name of Keynes, the major result of the Keynesian revolution was that it became generally accepted that governments had a countercyclical role to play in the management of the economy. There have, of course, been major arguments about the correct mix of expenditure, taxation and monetary policies to use to best realize countercyclical objectives, but governments are expected to intervene to prevent sustained recessions and unsustainable booms.

In the wake of the financial bubble bursting in 2007, and the ensuing crisis, governments followed the Keynesian orthodoxy of countercyclical activities. They ran government deficits, provided stimulus packages, encouraged central banks to keep interest rates low and intervened to prop up financial institutions facing liquidity constraints. These efforts, while not entirely offsetting the fallout for the real economy from the financial crisis, for the most part prevented declines in employment similar

to those experienced in the 1930s. They were not, however, sufficient to totally offset employment declines, causing consumers to rein in expenditures due to worries over the potential for further job losses. Further, consumers in a number of countries faced declines in housing prices, and hence their wealth or debt security, leading to attempts reduce personal debt load. Businesses, faced with flat domestic demand, were not investing in new capacity. Growth has remained elusive for developed economies. As a result, governments have had to continue deficit financing.

The economic growth that would raise tax revenues and reduce expenditures on unemployment benefits and other social welfare transfers has stubbornly refused to materialize. While there has been considerable growth in the developing world, particularly in Asia and South America, its spillover to developed countries has been largely limited to countries such as Germany with specialized and high-quality capital equipment to sell and Canada and Australia with sought-after natural resources. For most countries, foreign demand did not have a discernible positive impact on growth. Competition from developing economies has meant rising energy prices, further squeezing the budgets of households and firms in developed countries.

In a number of European countries, primarily but not exclusively those where there was a housing bubble that broke in the wake of the financial crisis, continued borrowing to finance government deficits became problematic. As a result, these governments have been forced to attempt to rein in their deficits through draconian reductions in expenditures and/or radical increases in taxes. In circumstances of general economic malaise, these austerity measures have had the same effect as attempts to balance budgets in the early 1930s – declines in consumer confidence and less purchasing of private sector output by governments and businesses facing higher taxes (or reduced opportunities for tax avoidance). It is a classic example of the *paradox of thrift* (Samuelson and Scott, 1966), whereby the rational decisions of consumers and businesses to *tighten their belts* lead to pro-cyclical economic outcomes.

There is a new pro-cyclical element to the austerity measures taken by governments in 2010 and 2011 that was not present in the early 1930s. The proportion of national economic activity accounted for by government has risen consistently since the Great Depression to reach between 40 and 50 percent for most developed economies (Kerr, 2009). In the wake of the Keynesian revolution, government employees and their salaries have been seen as part of the solution rather than part of the problem. One key aspect of countercyclical economic policy is *automatic stabilizers* – institutional arrangements that do not require legislative or proactive budgetary activities by governments. The most obvious example of an automatic

stabilizer is government unemployment insurance which automatically begins making payments to workers who are made redundant. This puts money in the hands of the unemployed, thus reducing the decline in aggregate demand. Progressive income taxes operate in a similar fashion when incomes fall. Although not as countercyclical as these institutional arrangements, not reducing employment in the government and maintaining public sector wages when the private sector is moving into recession act to support demand. Austerity measures in countries such as Greece and the United Kingdom in 2010 and 2011 have required both reductions in the wages and/or benefits of government workers, and reductions in the size of the civil service. These represent direct reductions in aggregate demand. In addition, however, worries about job losses among members of the civil service have the same psychological effect as they have in the case of private-sector workers. In anticipation of the possibility of losing one's job in the future, individuals act to reduce their debt load/build up their savings. Of course, these precautionary reductions in expenditures contribute to the decline in demand and, hence, are pro-cyclical. Thus, the negative effect on demand of job losses and wage declines in the public sector is much larger than the actual reductions in government expenditures. This heightened anxiety effect on personal expenditures appears not to have been anticipated, for example, by the British government in its attempts to balance its budget after the major expenditures made to stabilize its financial sector in 2008 and 2009. It made *major public announcements* about extensive future job losses in the civil service. These job reduction targets were sufficiently ambitious and opaque to reduce the confidence of almost any civil servant in their continued employment in the public sector. The results should have been anticipated.

It has been popular to brand European governments (and in some cases whole societies) that are pushing up on their sovereign debt limits as being profligate while, in reality, their deficits would have been manageable if there had been the expected return to economic growth. It seems clear that, just as in the 1930s when the effects of the stock market crash of 1929 on the real economy were poorly understood and underestimated, the effects of the financial crisis that started in 2007 were largely unanticipated and underestimated. It was assumed that ensuring sufficient liquidity combined with a moderate degree of government stimulus would be sufficient to return developed countries to sustained, if moderate, growth. The forecasts of economic activity in developed countries for 2010 and 2011 put out by major institutions such as the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) have had to be consistently revised downward. Projections for the best of the major developed economies at the

beginning of 2012 are for modest growth at best. Many countries in Europe are expected to achieve no growth, and a few are expected to experience recessions. None has sufficient projected growth to provide the number of jobs to reduce politically unacceptable levels of unemployment and the increased tax revenues to alleviate difficulties in managing government debt levels. It appears as though the adjustments required in the wake of the financial crisis have simply been too large for many governments to manage. The limits of the Keynesian *fix* may have been reached. There is no clear way to easily return to sustained economic growth. Governments have pulled all the domestic economic levers available, low interest rates and stimulus, with little sustained effect other than rising deficits and debt. Certainly, a 1930s style depression has been avoided but neither is there rapid sustained growth. Governments are very constrained, threading a fine line with only the ability, at best, to stabilize demand while struggling to remain fiscally responsible. These narrow policy constraints do not provide politically convenient options for policy makers.

The real lesson is that booms that are allowed to turn into bubbles will burst, and the consequences may be beyond governments' ability to manage successfully. Thus, there needs to be more proactive management of booms. Of course, successfully limiting the excesses of a boom has always proved very difficult because no one wants to be the one to *spoil the party*. There is, however, considerable regulatory reform currently underway that will hopefully prevent a repeat of the 2007-2008 financial crisis. While this work is undoubtedly required, it is a bit like *closing the barn door after the horses have escaped*. Unfortunately, the source of bubbles tends to shift – from tulip bulbs to south sea enthusiasms to common stocks to sub-prime mortgages and the illusion of fully diversified risk.

International Cooperation and Recessions

While it is easy to criticise those policy makers who failed to prevent the financial collapse, the real question is what will happen now that developed-country governments are faced with the potential of a long period of poor economic performance and, in particular, high and sustained levels of unemployment. If, as appears likely, developed-country governments have exhausted all of the domestic policy levers that can normally be used to stimulate economic growth, then one obvious avenue would be to seek solutions in the external policy realm. There are two major external policy avenues that have the potential to provide an impetus for economic growth. These are imposition of trade barriers and strategic devaluation of the exchange rate. The first attempts to stimulate domestic employment by forcing the substitution of domestically produced goods and services for those of foreign origin.

This is classic protectionism. The second is to grow the export sector through devaluation. The employment export growth provides by making domestically produced goods and services cheaper for foreign customers to buy has the added benefit that at the same time it makes foreign goods more expensive, thereby forcing the same substitution to consuming domestically produced products as is the case through the erection of trade barriers. In both cases, altering trade flows provide the stimulus for growth. Hence, devaluation may appear a politically convenient policy option.

Of course, both protectionism and devaluation are naïve because, to have the desired effect, they require that trade partners take no action in response. The use of strategic devaluations and the erection of trade barriers, of course, negatively impact trading partners; these strategies are, in effect, attempts to shift domestic economic pain onto foreigners – which is also part of the reason they can appear convenient for politicians. If foreign governments retaliate by imposing trade barriers or engaging in their own strategic devaluation, this can lead to non-cooperative *beggar thy neighbour* rounds of disruptive re-retaliation. This was the experience of the 1930s. It was a hard lesson learned by the policy makers of the time.

When they set about to establish a new post-war international order as the Second World War drew to its close, those same policy makers understood the need to encourage cooperative solutions to international conflicts rather than destructive, non-cooperative solutions. The mechanism they chose to accomplish this objective was the establishment of formal international organizations to seek cooperative solutions to what they perceived as the four sources of international conflict: (1) political impasses; (2) differences in living standards; (3) the imposition of trade barriers and; (4) strategic devaluations (Kerr, 2010a). Prior to the Second World War there had been a formal international organization to address only one of these four sources of conflict – political conflict. This was the League of Nations established in the wake of the First World War. The League did, however, establish committees to work toward cooperative solutions to the economic sources of international conflict (Pauly, 1996). The failed World Monetary and Economic Conference held in London in June 1933 just prior to Keynes' observations in the *Daily Mail* that began this article was one such League of Nations–sponsored attempt at a cooperative solution.

To replace the failed League of Nations to deal with political conflict, a new (and improved) United Nations was established. To deal with differences in levels of economic capability the International Bank for Reconstruction and Development – or, as it is more commonly called, the World Bank – was established as a result of negotiations held at Bretton Woods in July 1944. To deal with the imposition of trade

barriers, an International Trade Organization (ITO) was negotiated in Havana in 1947-48 (Kerr, 2010b). Although the ITO never came into being because the agreement to establish it would not have been approved by the U.S. Congress, one of its sub-agreements, the General Agreement on Tariffs and Trade (GATT) became the *de facto* international institution to deal cooperatively with potential conflicts over barriers to international trade. The final organization, to deal with potential conflicts over strategic devaluations, was the International Monetary Fund (IMF); again a result of the negotiations at Bretton Woods.

These multilateral organizations have proved to be robust, durable and adaptable. Although they have not been able to eliminate non-cooperative solutions in situations of conflict, there is little doubt that they have reduced their impact. For example, the World Trade Organization (WTO), which arose out of the GATT Uruguay Round (1986-1994) negotiations, appears to have been sufficiently influential to prevent politicians from embarking on a spate of tariff increases[3] in the 2008 recession, as their predecessors had done in the 1930s (Viju and Kerr, 2011). In part, this reflects the political will expressed in the joint statements coming out of G-8 and G-20 meetings, whereby politicians cooperatively eschew the raising of trade barriers; in part, it is due to the transaction costs imposed by the institutional commitments associated with the WTO (Viju and Kerr, forthcoming). In any case, the lessons of the 1930s regarding *beggar thy neighbour* trade wars have not been forgotten and the institutional arrangements put in place after the Great Depression's non-cooperative era have worked as they were intended.

With the imposition of trade barriers effectively closed off as a convenient policy to provide an engine for domestic economic growth, this leaves strategic devaluation. It is clear neither that the lessons of the 1930s are current among political decision makers nor that the multilateral institution is sufficiently robust to deter attempts to engage in strategic devaluations in 2012 and beyond. Of course, a strategic devaluation is likely to lead to retaliatory devaluations and a descent into the downward spiral of *beggar thy neighbour* devaluations. This was well understood by those attempting to shape a new world order for the post–Great Depression era. In a speech to a meeting of European Allies on February 26, 1943, Keynes suggested:

> We should like to have some agreed system to prevent competitive exchange depreciations. Exchanges have to be altered from time to time because the social and wage policies of different countries do not keep step with one another necessarily but there should be no exchange depreciations which are merely passing on one country's perplexities to neighbours. Some provision should be made against that.[4]

The eventual organization established to deal with the concern expressed about strategic devaluations by Keynes (and many others) was the IMF. It was, however, designed for an era of fixed exchange rates. While the IMF survives, thinking on international economics has evolved, with the current norm being floating exchange rates – although seldom freely floating exchange rates, as governments often intervene to alter exchange rates to varying degrees. Some countries such as China intervene heavily on a continuous basis while many other countries have a much lighter touch. Having said that, the use of strategic devaluations by developed countries has seldom occurred in the last three decades. The IMF has had sufficient resources to support individual developing and transition economies' currencies if governments are willing to implement the reforms the institution requires as a condition of its assistance. The IMF, however, does not have sufficient resources to support the currency of a major developing country. Hence, in response to the recession following the financial crisis that commenced in 2007, the IMF has received a substantial increase in its resources, but it is generally agreed that these are still not sufficient for the institution to deal with a major crisis on its own.

The United States, because of its position as the issuer of the international reserve currency, is a special case. As a result, much of the focus has been on countries that use the euro as their currency. A number of euro using countries are portrayed as having no policy options because they are unable to devalue. In reality, they are no different from individual states or provinces in federal states (Reeves and Kerr, 1985). The finances of states such as California have been at least as shambolic as those of Greece or Portugal for decades, although for different reasons. No one suggests that California should abandon the dollar as its currency and issue *califlorins* that they could then strategically devaluate to spur growth. Greece could default on its debt without having to leave the euro – and in fact the 50 percent *haircut* on privately held Greek debt agreed at the summit on October 27, 2011 (*The Economist*, 2011) represents exactly such a default. It was, of course, pre-agreed and *orderly*. Certainly, a unilateral default by a member of the Eurozone would weaken the confidence of the international investor community in the capacity of individual countries to manage their debts, but in and of itself it would not lead to the abandonment of the currency. Federal states have to deal with a wide range of economic stresses while keeping a common currency (Reeves and Kerr, 1986). Thus, when German Chancellor Angela Merkel and French President Nicholas Sarkozy bluntly told Greek Prime Minister Papandreou prior to the G-20 summit on November 3, 2011 that the referendum on the bailout package he had proposed would have to be a simple vote on Greece

continuing to use the euro, they were using the threat of the chaos that leaving the euro would mean for Greece as leverage to have the proposed vote cancelled.

Behind the crisis management of the sovereign debt problems lurks the possibility of a number of countries leaving the euro so that strategic devaluations could be attempted. EU member states that retain their own currencies may also be considering the strategic devaluation option – primarily to foster economic growth. Devaluation is not, however, a *magic bullet* that can solve a country's economic problems. While it helps exports, it also raises the costs of imported inputs used by exporting firms – so the net effect may be much smaller than expected. Consumers face higher prices for imported products and, hence, are poorer in just the same way as they would be after a rise in domestic taxes. Debts denominated in the national currency held by foreigners decrease in value and, hence, are a *de facto* partial default, and can be expected to have the same effect on investors' confidence. Thus, while increased exports and import substitution are expected to lead growth, the actual boost to the domestic economy may be considerably muted. Devaluations lead to considerable turmoil for firms as relative prices take time to adjust, making contract setting and investment decisions more difficult and more risky.

The political convenience of strategic devaluation is premised on the naïve assumption that trading partners won't retaliate. While some modest adjustments in the exchange rate, such as a decline of *sterling* against the euro, could take place without retaliation, relative movements sufficient to stimulate significant economic growth would surely trigger retaliation. Small economies might successfully engage in strategic devaluations because their impact on the economies of major currencies might be sufficiently limited to be ignored. Success by one small country, however, would likely spur copycats whose cumulative economic effect could not be ignored. Further, small economies may compete directly in markets such as tourism. As a result, any advantage gained could be negated by other small-country competitors retaliating. *Beggar thy neighbour* rounds of strategic devaluations lead to constant price disequilibrium, which raises the level of risk for businesses. This increase in risk will inhibit investment, which can have detrimental long-run effects. Strategic devaluation is not likely to prove to be as politically convenient as some decision makers may assume.

Conclusion

The major long-term problem arising from the fallout from the financial crisis that started in 2007 is that the developed countries have failed in their attempts to return their economies to paths of sustained growth. Beyond reducing unemployment,

growth is required to increase tax revenues so that the need to finance government expenditures through borrowing is reduced. Some developed-country governments, however, have reached the limits of their ability to borrow to finance government deficits, forcing a movement to pro-cyclical fiscal policies such as expenditure reductions and/or tax increases. In most cases their central bank interest rates are near or at their lower limit. As a result, governments have exhausted the domestic policy levers they have available to stimulate growth and are considering external trade and currency policies as alternatives.

In the case of trade restrictions, the lessons of the 1930s appear to have retained their currency with policy makers. In the case of strategic devaluation, the restraining force of history may not have as much efficacy. Strategic devaluation may appear as a convenient policy avenue to escape negative or near zero growth. Strategic devaluation will only be a successful policy if other countries take no notice. Policies that act in the international sphere, however, impose costs on foreign economies, eliciting retaliation – a non-cooperative response. The lesson of the 1930s is that the non-cooperative outcome is likely to be inferior to the cooperative outcome, although policy makers in that era did not express the results in that way. Their activities after the Great Depression, however, were all aimed at ensuring that non-cooperative solutions were not again embraced by economic policy makers for reasons of political convenience.

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Endnotes

1. Reprinted in Keynes and Moggridge (1982), p. 250.
2. *Prosperity is just around the corner* was the famous slogan of U.S. President Herbert Hoover in the early 1930s.
3. Or the imposition of other trade barriers.
4. Reprinted in Keynes and Moggridge (1980), p. 208.