An explicit UK policy for a lower exchange rate will not boost economic growth as some have suggested

Apr 27 2012

Philip Booth *argues that lower exchange rates is not the solution for the problem of stimulating economic growth in the UK. It is real exchange rates that determine the cost of exports and imports relative to alternatives, and, since the UK can only control nominal rather than real exchange rates, there is not much by way of policy that can actually be done in this respect.*

A brief pamphlet has recently been published by Civitas, written by John Mills – 'A Price that Matters'. This pamphlet makes the case that the UK should have an explicit policy for a lower exchange rate in order to ensure that Britain can export more, increase economic growth and generally pay its way in the world. Mills describes existing policies focused on inflation targeting as 'deeply flawed'. Certainly, we have a problem with economic growth. And there may well be better alternatives to inflation targeting – such as price-level targeting or wholesale reforms of central banking. However, Mills' approach is not the solution.

The fact that, in his section on possible objections to a lower exchange rate, none of the important objections that economists would cite are covered, should ring alarm bells. Furthermore, the fact that it is suggested that a devaluation of 50 per cent would lead to our economic growth rising to 10 per cent annum should lead to general incredulity. No distinction is made in the analysis between the real and nominal exchange rates – and, yet, that is the crux of the matter. Countries can control their nominal exchange rates but they cannot control their real exchange rates. It is real exchange rates and not nominal exchange rates that determine whether exports are cheaper and imports more expensive.

If, for example, there is a 20 per cent devaluation but the internal price level rises by 20 per cent, exporters and those competing with importers are no better or worse off than if there had been no devaluation at all. The process of loosening monetary policy to bring about the devaluation would, indeed, lead to a rise in the internal price level. Would the rise in the internal price level be as great as the fall in the exchange rate? It almost certainly would be because the underlying real factors that determine real exchange rates would be unchanged.

'What about China' you may ask? Has China not pursued a low exchange rate policy with success? You may equally ask, 'what about the UK in the time it was deutsche mark shadowing in the late 1980s?' In both these cases, countries have pursued de facto exchange rate targets (a lower exchange rate). But, in both these cases, inflation soon followed. The UK tried in vain both to prevent inflation and prevent the currency rising in value in 1988. The currency intervention was 'sterilised' – that is bonds were issued to soak up the additional money that was created. But, if those bonds are bought by overseas investors, the pressure on the exchange rate remains and, if those bonds are bought by domestic investors, inflation is sure to appear – and it did. Indeed, China today is suffering from inflation and Britain in the late 1980s suffered high inflation. Furthermore, we should not forget that the pain of reducing the UK's inflation in the late 1980s was huge.

Mills rightly points to some short-term episodes of the benefits of lower exchange rates – the UK in the late 1930s and again in the early 1990s. The point is that the benefits were, indeed, short-term. A lower exchange rate, in the short-term, will increase economic activity and favour exporters. However, businesses will be responding to price signals that cannot be maintained and the painful reallocation of resources will have to take place once the short-term benefit has come to an end.

Maintaining the low exchange rate will require loose monetary policy and this will bring about inflation and a rise in the internal price level. However, the most pertinent point about the late 1930s and early 1990s is not that benefits flowed from lower exchange rates as such, but that floating exchange rates allowed the UK to return to a reasonable monetary policy stance after a period of unreasonably tight policy.

To return to my initial theme, it is real exchange rates that determine the cost of exports and imports relative to alternatives. Real exchange rates are determined by real factors – they are only a function of monetary policy in the short term. The most pertinent of these real factors in the UK (and the US, for that matter) is the level of private saving and government borrowing. If a country is a net borrower, the counterpart of this must be a balance of payments deficit. The inflow of capital will bid up the exchange rate and bring this counterpart about.

We are buying goods from China today and promising to pay for them, not in exports today, but in exports tomorrow. These trends can be reversed. It would help if the government cut its borrowing and did not discourage saving. Elsewhere, as the Japanese population continues to age, they will become net dis-savers, and so on. Of course, Chinese households are saving as if there is no tomorrow (or, perhaps, as if there is no today…). The export of capital lowers the Chinese exchange rate and is the counterpart of the net export of goods and services which are produced but not consumed.

The UK does not incur debts because its exchange rate is too high. We run a trade deficit because we choose to incur debts. Japanese households have not accumulated assets overseas because their exchange rate is weak – their exchange rate has been weaker than it would have been because households have accumulated assets overseas. At least in the long-term (that is in the planning horizon of a business) it is as simple as this: monetary policy affects nominal exchange rates; real factors affect real exchange rates.

About the author

Philip Booth *is Editorial and Programme Director at the Institute of Economic Affairs and Professor of Insurance and Risk Management at Cass Business School, City University. He has previously worked at the Bank of England advising on financial stability issues. He has co-authored and edited a number of books including "Verdict on the Crash" and "Investment Mathematics and Statistics*

You may also be interested in the following posts (automatically generated):

1. Arguments linking a lower corporation tax to increased productivity and growth have no basis in reality
2. Osborne should make cuts from low-growth areas, and recycle the money into high-impact spending to boost the economy while sticking to the deficit reduction plan
3. Plan B is the wrong rhetoric, but the Treasury must spell out a strategic vision for the UK's economic growth
4. Policy uncertainty is threatening economic recovery