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ONE ECONOMIST'S VIEW

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DEVALUATION, INFLATION AND IMPOVERISHMENT: AN INTERPRETATION OF THE CURRENT POSITION OF THE AMERICAN ECONOMY

SUMMARY-THE IMPACT OF THE DEVALUATION OF THE DOLLAR UPON THE ECONOMIC OUTLOOK

The devaluation of the dollar since August of 1971 is a cause of the current inflation and an important factor determining both the near and longer term economic outlook.

The devaluations made the United States poorer relative to the other affluent economies. In the context of world-wide supply shortages, this relative impoverishment means that in absolute terms some dimensions of the United States standard of life must decline.

The ongoing inflation is due to the way the market mechanism tries to affect this reduction. Inflation is both inefficient and inequitable: correct policy can facilitate the required adjustments and distribute the burden in a more equitable way. But correct policy can only result if the fact of impoverishment is accepted.

As yet, there is no sign that the political and economic leadership is aware of this fact. Therefore, the prospect is that economic policy will continue to be counter-productive, as it has been for 4-1/2 years. This means that further inflation and even additional deterioration in the United States international economic position lies ahead.

Furthermore, if policy makers accept the argument that the inflation is due to an excessive growth of the money supply beyond that required to accommodate the financing needs triggered by the devaluations, then serious financial distress is likely to surface -- as in 1966 and 1969-70. If this distress is not promptly offset by the Federal Reserve, the impoverization of the United States may well take the form of a serious recession.

Thus, the current situation is one in which standard monetary and fiscal policy prescriptions will not constrain inflation at an acceptable cost; economic policy to be successful will have to go beyond the standard prescriptions.

ARGUMENT-THE SCOPE OF THE DEVALUATIONS

The devaluation of the dollar, with respect to the German Mark, the Japanese Yen, and other major currencies, since August 1971 has been huge.

These currencies have appreciated between 35% and 50%. This has taken place in three stages: the first led to an establishment of new parities in January 1972, the second was the formal devaluation of February 1973, and the third is the float of the dollar since February 1973.

Exchange Rates

Cents per unit of Foreign Currency

Country	July 1971	March 1972	February 1973	July 1973
Germany	28.728	31.545	33.273	42.821
Japan	.27980	.33054	.36041	.37801
Netherlands	28.097	31.384	33.119	38.700
Switzerland	24.423	25.974	25.326	35.428
Appreciation with respect to the dollar since July, 1971:				
Germany		1.098	1.158	1.491
Japan		1.181	1.288	1.351
Netherlands		1.117	1.179	1.377
Switzerland		1.064	1.201	1.451

Source: Federal Reserve Bulletins

Of the currencies listed, the German Mark has appreciated the most. The 49% appreciation of the German Mark breaks down as follows: some 10% in the initial revaluation of 1971-72, a 6% appreciation in February 1973 and a further 34% (against the original base) appreciation during the float. (Since July 1973 there has been a slight (5%) improvement in the value of the Dollar as against the Mark.)

The largest part of the devaluations with respect to the European currencies has taken place since the float. For the Japanese Yen the official devaluations constitute the major part of the total change in exchange rates.

THE SIGNIFICANCE OF THE DEVALUATION

The dollar devaluations have had two effects. The effect that has been emphasized is that the prices of goods produced in the United States have fallen relative to the prices of goods produced in the appreciating countries; the price of a Vega has fallen relative to that of a Volkswagen in the United States, in Germany, and in third countries. This change implies that a substitution of United States for German and, say, Japanese goods will take place.

Another effect, which is perhaps more important, has not been emphasized; the devaluation of the dollar translates into a large increase in the dollar value of both the national income of and personal incomes within the appreciating countries. A 45% appreciation of the German Mark means that the dollar value of the Gross National Product of Germany increases by 45%, above and beyond the increase that takes place because of internal economic growth. Similar though smaller increases have taken place in the dollar value of the Gross National Product of other appreciating countries.

As a result of the devaluations, the United States is no longer "number one" in per capita income. The dollar value of the 1970 Gross National Product per capita of Sweden and Switzerland at the exchange rates ruling in July, 1973 exceeds that of the United States; the dollar value of the West German per capita Gross National Product is 96% of that of the United States.

DOLLAR VALUE OF 1970 GROSS NATIONAL PRODUCT PER CAPITA

Computed at 1970 and 1973 Exchange Rates - Selected Affluent Countries

1970 GROSS NATIONAL PRODUCT PER CAPITA

	Dollar Value		Ratio to U.S.	
	1970 Exchange Rates	1973 Exchange Rates	1970 Exchange Rates	1973 Exchange Rates
Germany (West)	$2,930	$4,574	.62	.96
Denmark	3,190	4,316	.67	.91
Netherlands	2,430	3,402	.51	.71
Switzerland	3,320	5,070	.70	1.07
Australia	2,820	3,590	.59	.75
Sweden	4,040	5,183	.85	1.09
Japan	1,920	2,600	.40	.55
United States	4,760	4,760	1.00	1.00

Source: World Bank, Trends in Developing Countries 1973.

A sharp increase in the dollar equivalent incomes of these countries has taken place. Such an increase in income, no matter how it is brought about, leads to sharp increases in demand for a broad spectrum of goods and services.

To put it quite generally, the devaluations of the past two years, when translated into income increases in the appreciating countries, increased the dollar demand so that for many products the quantity demanded at the ruling prices became greater than the quantity available. This was particularly true for items whose world prices were denominated in dollars and whose world demand was dominated by American demand.

The huge increase in the dollar equivalent of the incomes of the appreciating countries led to increases in the demand for an improved diet (protein foods) and fuel. Thus, with a short lag, price pressures affected the markets for meat, feed grains, and petroleum. Furthermore, as most basic industrial commodity prices are denominated in dollars, they suddenly became relatively cheap to the appreciating countries. This led to excess demand and rising dollar prices for such commodities.

Thus, the devaluations of 1971-73 in and of themselves triggered rising dollar prices in many markets.

THE IMPOVERIZATION OF THE UNITED STATES

The huge increase in the dollar value of the national and personal incomes of the appreciating affluent countries meant that the United States became relatively impoverished. The United States is now not as rich as compared to these other countries as it was in 1971. This change took place in a world in which most of the rich countries are at or close to full employment. Thus there was not much unused capacity available to expand the production of manufactured goods or of basic commodities. The relative impoverization of the United States, in the context of a full employment world, means that some absolute declines have to take place in some components of the United States Gross National Product.

The devaluations only tell us that the United States is now poorer. They do not pinpoint which dimensions of final demand will decline, nor do they select whose real income will fall. Impoverization means that some combination of real consumption, investment, and government demand needs to fall.

Initially, the devaluations meant that the quantity demanded at the ruling dollar prices became greater than the quantity supplied. The market reaction to such demand conditions in a world where supplies cannot increase because of full employment and capacity limitations takes the form of rising prices. If money incomes do not change, such rising prices will cut demand. The current inflation is the result of the way in which the market mechanism is trying to affect the required impoverization of the United States. The inflation tries to select where the reductions will take place and who will suffer a decline in real income.

THE INEFFICIENCY OF THE RESPONSE

A broad generalized inflation is an inefficient and inequitable way to effect and distribute a decline in real income. This is so both because of the way in which the market mechanism operates and because of the political response. It would be more efficient to use policy measures to help market processes select the demands and the incomes that will be cut.

One reason the market is inefficient is that many price increases are immediately transformed into increases in dollar incomes. Thus, the higher dollar prices of agricultural products implies higher farm incomes, higher farm incomes increase the demand for agricultural machinery, and this, in turn, leads to increased wages and profit income for the affected workers and firms which, in turn, implies increased demand for agricultural products.

Thus, the excess demands due to the devaluation lead to income increases which, in turn, lead to further increases in demand; inflation generates further inflationary pressures.

Furthermore, where higher prices tend to squeeze out demand and reduce output, the government and private organizations, reacting to the inequity of the market's selection process, intervene to protect the affected. Thus, social security payments, government employment pay scales, and military pay (and retirement benefits) all respond to rising prices by increasing money

payouts. Trade unions have inflation clauses in their contracts and base wage demands on prices. Contractors, who can pass wage increases on to the government do not really resist wage increases; neither do firms such as the automobile manufacturers, whose foreign competition has been decreased by the devaluations.

Interest rate increases are a way the market tries to reduce externally financed demand. An inflation means that financing needs increase thus inducing higher interest rates. High, and rising, interest rates, in the context of United States institutions, tend to have a disproportionate effect upon housing demand. However, as housing is a political sacred cow, the Administration and Congress intervene to insulate housing demand from the effects of rising interest rates.

We therefore have an inflationary process, that is presumably a mechanism to decrease real demand, and market and political processes that tend to offset such reductions by feeding additional money demand into the system.

NEAR TERM IMPLICATIONS

It is likely that product markets have not as yet felt the full impact of the rise in incomes of the appreciating countries. In particular, as the food and energy consumption standards of these countries complete their adjustment to their newfound affluence, further price pressures can be expected. Furthermore, United States wages and the prices of domestic manufactured products and services have not fully adjusted to the price and cost changes. Thus continued inflation, though at a slower rate than in the summer of 1973, can be expected in 1974.

As a result of the price changes induced by the devaluations, we can expect United States households to spend a significantly higher proportion of their family budget on food and energy than hitherto. If household discretionary spending habits persist, then the near term ratio of household saving to household income will decline. If such a decline takes place, households will be an overall stimulus to the economy in late 1973 - early 1974. [The coming Christmas season is a key test of whether household discretionary spending will persist in the face of the increased expenditures on food and fuel: a good Christmas season will indicate that 1974 will be strong.]

The continued strong foreign demand combined with higher dollar demand from American households implies a strong prosperity in agriculture for the next several years. This agricultural prosperity will spill over to industries that provide agricultural implements, chemicals, and services. The spillover will likely be so strong that demand will press capacity, thus inducing capacity increasing investment.

Because of the above it is difficult to envisage any significant falling away from high employment in 1974. The combination of high employment and continued inflation means that with occasional lapses the Federal Reserve will sustain what it considers to be the maximum feasible constraint. Thus with some slight movements, short-term interest rates should remain on a high plateau, and long-term rates might very well rise a bit through the first part of 1974.

Continued high long-term interest rates might well lead to a decline in housing.

Inflationary expectations should make consumers willing to go into debt. What happens to the demand for durables depends upon whether the lenders' terms will fully reflect anticipated inflation, and whether lenders react to the increased drain of food, etc. upon the budget by decreasing the amount of debt that any take-home income can support.

Thus the economy is on an inflationary treadmill. As the economy is now operating, the particular real standard that is reduced at any moment of time is the result of a "lottery": it depends upon where in the cycle of money income and price increases the economy happens to be. Such an inflationary treadmill, with its rotating declines and catchups in real income, will erode the improvement in international prices due to the devaluations and therefore decrease the favorable effect upon our balance of payments. The inflationary spiral may very well lead to further devaluations, which will lead to renewed inflationary pressures. Market processes can worsen rather than improve the situation.

THE NATURE OF INEPT POLICY

A depression, or recession, is one way of achieving and allocating impoverization.

A continuing inflation will be accompanied by accommodating increases in the money supply made possible by the Federal Reserve System feeding Reserve Money into the banking system. This Federal Reserve behavior will be mainly due to its unwillingness to risk financial instability, similar to the crunch of 1966 and the Penn-Central crisis of 1970, that could follow upon too great a slowdown in monetary growth relative to the growth of the money value of income and the money value of financial obligations.

Thus, after the fact, the data will show that the money supply has grown at approximately the same rate as money income. Given the current popularity of the view that excessive growth of the money supply is the primary cause of excessive growth in money income, a clamor might well go up that the Federal Reserve is responsible for the inflation and that the inflation can be stopped by cutting the rate of growth of the money supply. The argument might well take the form that the fear of financial instability is exaggerated: a little crunch, as in 1966, or a bit of a squeeze, as in 1969-70, will not hurt.

If this view is taken up by the political leadership, the Federal Reserve might very well go along and sharply cut the rate of growth of the reserve base and hold to the lower rate as financial markets become distressed. The end result would be more serious recession than any experienced since the end of World War II. At this particular juncture, policy based upon a wrong analysis can have most serious consequences.

LONGER TERMS IMPLICATIONS: THE NATURE OF APT POLICY

All in all, the prospect of either continued inflation accompanied by further devaluations or a serious recession is not appetizing. Apt policy would aim to eliminate inflation without triggering a recession or depression.

Before such policies can be adopted, the political leadership needs to face the fact of our impoverization and be willing to make the responsible decisions with respect to tax, spending, income maintenance, and social programs that will cut chosen dimensions of our private and government real takings and which distributes the burden in an acceptable way.

The float of the dollar can be interpreted as a gigantic evasion of responsibility. If, after the first or second devaluation, a program to protect the newly-established exchange value of the dollar had been adopted, measures would have been taken to cut expenditures on military bases abroad, reduce defense spending, increase personal and corporate income taxes, impose excise taxes on fuel and automobiles, and introduce tariffs on "luxury" imports.

The measures that need to be taken to halt the inflation, to prevent further devaluations, and to prevent a depression, are very much like the measures that would have been taken if the Administration had undertaken to defend the dollar in February, 1973.

One issue that needs to be faced is the current effect of the prospective impact upon our balance of payments of the huge forecast dependence upon foreign oil. The forecast oil requirements generate a huge "nut" that our exports have to finance. The prospect is not good that our exports will make this "nut" even at the present exchange rates, particularly as lower exchange rates induce domestic inflation. The price of doing nothing about our oil and energy consumption is a continuing worsening in our terms of trade and further impoverization. There is a need to constrain the growth of gasoline consumption, which in turn implies positive policies to change the nature of the American automobile, and to undo the dependence of our urban areas upon the automobile.

Policy measures that would substitute for inflation in allocating the impoverization due to the devaluation, and which can satisfy our feelings about equity, might well include:

a) reductions in military spending
b) efforts to compact our urban complexes
c) decrease our emphasis upon construction.

In addition, many of our income maintenance, labor force participation, and job security policies, which introduce inefficiency in the economy, were adopted during the great depression, when the ability of government actions to sustain a close approximation to full employment was rightly questioned. The past twenty-five years have demonstrated that policy can maintain a close approximation to full employment, and thus many wasteful practices can now be eliminated. Such fuller and more efficient use of our capabilities can offset at least part of the impoverization that the devaluations impose.

It is clear that the devaluations and the float of the dollar have been a "bad thing" for the American economy. In a world with large scale unemployment, a lower exchange rate may trigger an expansion of employment and output and thus may be desirable. In a full employment world such as we now have, a lower exchange rate will initiate an impoverishment and an inflation. United States policy should be aimed at undoing at least the part of the devaluations due to the float. Apt monetary and fiscal policies combined with courageous policies which allocate and distribute the present impoverishment can achieve such a recovery.