L.A. Skeoch, M.A., Ph.D., F.R. Econ.S. *The Krona Devaluation and Some Long-run Considerations*

Bjarni Benediktsson – Stjórnmál – Bréf – Halldór Kr. Thorsteinsson -

BRA
JUN 16
3 PM

BY AIR MAIL
PAR AVION

Mr. Halldór Kr. Thorsteinsson

Háteigi, Háteigsveg 36

Reykjavík

ICELAND

Bjarni Benediktsson

The Krona Devaluation and Some Long-run Considerations

It has for a long time been obvious that the krona was appreciably overvalued and that sooner or later a substantial adjustment would be required. In many quarters recognition of the necessity for devaluation was decidedly laggard. The writer recalls the reactions of numerous business officials and others, varying from dogmatic disagreement to amused tolerance, to his forecast in the autumn of 1946 that a serious situation on current foreign exchange account would very probably develop within eighteen months. The failure of the herring fishery contributed to the realization of that unhappy prediction but the seeds of trouble were already at that time sprouting vigorously even though they were hidden by the lush growth of the war years.

The reasons for that forecast are not far to seek. During the war the high rate of expenditure by the Allied armed forces and the comparatively high returns from the export of fish and fish products provided large supplies of foreign exchange with which to meet the current demand for imports and the setting aside of foreign exchange reserves for post-war capital re-equipment, notably in the fishing and fish-processing industries. At the same time these factors pushed labour and other domestic costs to very high levels.

With the conclusion of the war the expenditures of the Allied armed forces were drastically reduced and, particularly with the return to production of the Norwegian fishing fleet, competition for markets increased . The effect of these factors was accentuated by the failure of the herring catch. Thus the dual sources of the war-time supply of foreign exchange were drying up almost simultaneously . But domestic incomes and costs remained high, thereby maintaining the demand for imports at a high level and hampering the export industry in meeting the increased competition. The necessary adjustment was certain to be severe and could not be long delayed without exposing the Icelandic fisheries and thus the economy as a whole to great danger.

In essence, the standard of living in Iceland had been increased under the impetus of abnormal war-time factors much more rapidly than the facts of her economic situation could warrant in the long-run. This fundamental fact may be temporarily disguised by one expedient or another and a good deal of social and political friction may be engendered by attempts to shift the unavoidable reduction from one economic group to another but it cannot be escaped. The Government apparently were convinced that an adequate reduction of costs of production and incomes through the lowering of wages was politically impossible and through the narrowing of profit margins, especially in the export industry, was economically impossible. The only reasonable alternative was to reduce the foreign value of the krona. How effective this policy will prove to be must depend upon future developments.

The immediate effect is the obviously desirable one of increasing the profitability (and so the output) of the export industry since domestic costs will not, for the time being at least, match the rise in the krona prices received by the exporters. However, in an economy so highly dependent on imports as is Iceland the effect of devaluation, especially a devaluation of the magnitude of $42\frac{1}{2}\%$, can be expected very quickly to show itself in a large increase in the cost of living. If, when this occurs, wages and other costs rise promptly to prevent any reduction in living standards the export industry will again find itself in difficulty. If, on the other hand, the Government attempt to offset the rise in living costs by a policy of subsidization the already existent inflationary pressures will be intensified to the explosive point. It will, in the end, prove to be impossible to run away from the painful economic reality which dictates a standard of living based upon the current international earning power of the economy and not upon the abnormally high income of the war years.

If a policy of devaluation was inevitable as a first step towards equilibrium what can be said of the magnitude of the change in the value of the krona that was decided upon? In the first place it is clear that a calculation based on the popular purchasing power parity formula is meaningless in the Icelandic situation. Such calculations are sufficiently precarious in the case of countries with a wide range of industries and which exchange a variety of products; in the case of a country with one export industry and very few domestic industries they are almost entirely irrelevant. The sole criterion must be that the devaluation should be sufficiently great, and only sufficiently great, to establish normally profitable conditions of production in the export fisheries. Devaluation beyond that level would encourage an expansion of output exceeding the capacity of the industry and create conditions favorable to inflation and subsequent collapse. Devaluation below that level would leave the fisheries in the doldrums.

Whether the first or the second formula - or possibly still some other - was used in determining the new value of the krona the writer has, of course, no way of knowing. Some rough calculations based (for lack of an Icelandic wholesale price index) on proportional changes in cost of living indices in Iceland and the U.S.A. and Great Britain suggest that the purchasing power pafity formula was not unimportant in setting the new krona value. Should this prove to be the case the attainment of equilibrium in the fishing industry would still not be impossible but it would be quite fortuitous. Even assuming that the degree of devaluation is appropriate to the needs of the export fisheries, for a balanced position to be attained there will be required an improvement in the budget situation as well as a restrictive credit policy.

There is, moreover, an underlying long-range structural problem which will continue to afflict the Icelandic economy long after the present inflationary tendecies have been satisfactorily dealt with. Iceland is an example, par excellence, of an economy dependent upon the export of one staple product subject to wide price fluctuations and to an increasing burden of fixed costs with changing techniques and markets and new systems of labour organization. In earlier years the processing of fish was carried out with a minimum of capital equipment; today huge capital investments in freezing and processing plants impose a heavy burden of fixed costs whatever the price of fish. A roughly parallel condition prevails for fishing vessels; the modern trawler is an enormously expensive piece of equipment on which fixed costs tend to become an increasingly large percentage of total costs. In both cases, of course, the modern techniques have greatly increased productivity but the increase has not been pure gain. The economy has been rendered much more rigid and consequently much more vulnerable to any decline in the price of fish. A substantial fall in fish prices quickly reduces returns below the level required to cover fixed costs, trawlers suffer heavy losses and are laid up, processing plants find themselves in dire straits, and unemployment and large-scale bankruptcy threaten.

What is required above all else in an economy subject to wide fluctuations in export income is flexibility, but partial rigidity imposed by the requirements of modern techniques is converted into something approaching petrification by the Icelandic policy which ties wages to the cost of living. Wage policy can realistically be tied only to the earning capacity of the economy - in the case of Iceland, to the level of export prices and the volume of exports. It need scarcely be added that there is not the most remote necessary connection between the movement of the level of export fish prices and the movement of the level of the cost of living (i.e. the level of import prices). The importance of a formula relating wages and other incomes to the value of exports was signally demonstrated by Australian experience during the depression of the 1930's. The significance of that experiment has, perhaps, been insufficiently appreciated by Icelandic economists, trade union officials, and Government representatives.

These long-range structural problems defy the therapy of devaluation. Successive doses of devaluation would merely mean resort to perpetual inflation, thereby confiscating the savings of the community and undermining the basis of a stable society.

Even with the adoption of a wage and other income policy related to export returns it is doubtful if the long-range problems can be fully solved through reliance on the staple commodities derived from the fisheries - at least without the negotiation of an international commodity agreement for the fishing industry. It is, furthermore, too early to say with certainty that the presumed advantages of commodity agreements will not prove to be illusory. Ideally, the risks to an economy characterized by high fixed domestic costs and widely fluctuating one-product export income are met by the development of a variety of more highly processed export products and of reasonably efficient processing industries for imports. The limited natural resources of Iceland undoubtedly present obstacles to the extensive use of the former policy, although the histories of Denmark, Belgium and Switzerland are not without instructive precedents. The latter policy would appear to possess attractive potentialities if applied imaginatively and vigorously. Whether part of the foreign exchange devoted to the high-cost post-war expansion of the trawler fleet could not have been better employed in launching carefully selected enterprises of this type is an interesting question for speculation. The answer can only be given from experience over the next few years. It is far from certain that it will be in the negative.

L.A. SKEOCH, M.A., Ph.D., F.R.Econ.S.