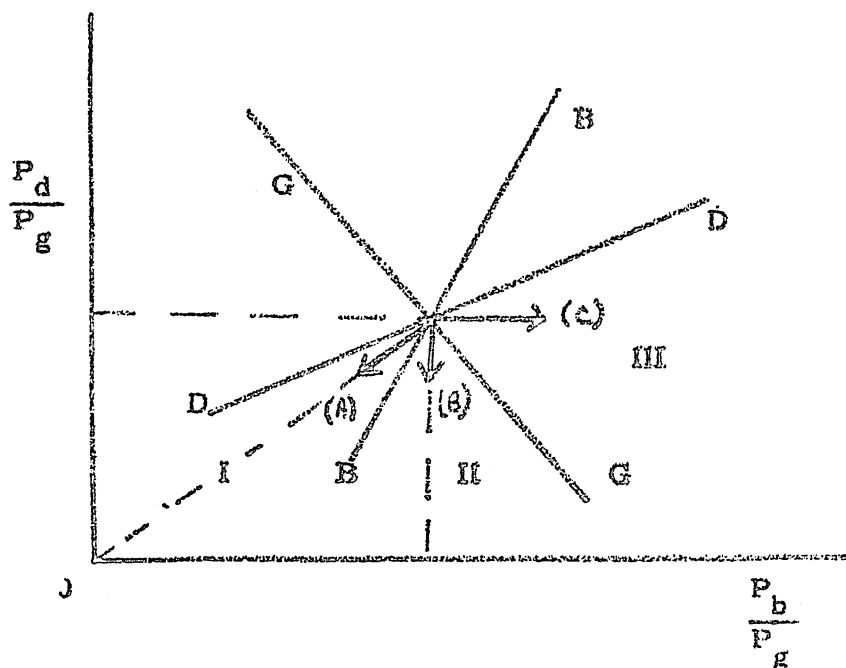


Figure 3



A country does not devalue unless it is in disequilibrium. Our concern is, ultimately, to find the circumstances of disequilibrium that justify devaluation. But to do so we need to know the effects of devaluation. So we start at the equilibrium Q and ask: What will be the consequences of devaluation?

We are thus back to the question posed in the beginning. What kind of devaluation are we talking about? Let us proceed systematically.

Devaluation in the sense (A) (a uniform reduction of par values) will move us to Zone I, where there is an excess supply of gold and an excess demand for dollars and sterling.

Devaluation in the sense (B) (a reduction in the par value of the dollar alone), will move us to Zone II where there is an excess demand for dollars and an excess supply of gold and sterling.

Devaluation in the sense (C) (an appreciation of other currencies) will move us to Zone III where there is an excess supply of pounds and an excess demand for gold and other currencies.

In all three cases the devaluation increases the excess demand for dollars, though by different amounts. In case (A) the pound is strengthened while in cases (B) and (C) it is weakened. In case (C) the excess demand for gold is increased while in cases (A) and (B) it is reduced. The choice of policies depends, therefore, on which of the different side effects are beneficial. We have to know the current state of basic forces in the market.

I have now slipped into the habit of speaking as if I am indeed talking about balance of payments and exchange rates, whereas I initially said that gold, dollars and sterling were any three goods. There are many complications that need to be taken into account when making the transition from the model to the real world. The problem has to do with the multiplicity of currencies, and other markets; another problem concerns balance of stocks in relation to flows. Actually, these problems are readily handled by general equilibrium methods but the above analysis suffices for an introduction to the problem.