

## EXCHANGE RATE POLICIES IN DEVELOPING COUNTRIES

Since the early 1970s a large proportion of less developed countries (lDCs) have experienced substantial balance of payments difficulties arising from greater turbulence in the world economy. Most have therefore found it necessary to initiate economic adjustments to restore balance of payments viability, which have frequently entailed changes in their rates of exchange. But the collapse of the Bretton Woods system of fixed exchange rates in the early 1970s, and the resultant floating of the major currencies, has made the task of lDC exchange rate management more complex. Under the fixed exchange rate system the maintenance of the level of an lDC currency against one principal currency gave it stability with respect to the other major trading currencies, excepting infrequent devaluation by the developed countries. This made it easier to monitor the competitiveness of its exports. In the present system the major currencies have undergone large fluctuations against each other, and an lDC must now pursue a more flexible exchange rate policy than in the fixed exchange rate world, if it is to avoid losing international competitiveness.

However, exchange rate adjustment is a controversial policy. Dispute centres on a number of issues, including the contribution of 'inappropriate' exchange rate policies to balance of payments difficulties in lDCs, the role of devaluation in restoring balance of payments viability and the degree to which it must be co-ordinated with other policy measures. The exchange rate policy adopted may also have important effects on income distribution in lDCs, which in turn can have political significance. Devaluation is often a policy condition in adjustment programmes supported by the International Monetary Fund and the World Bank, and the size of the required devaluation has been a source of considerable dispute between the multilateral agencies and a number of lDCs.

### Maintaining international competitiveness

Alterations in exchange rates affect an economy through changing its *structure of prices and thus incentives*. An appreciation of a country's *nominal* exchange rates will, other things being equal, increase the incentive to consume imports and reduce the incentive to produce exports and import substitutes. With the acceleration of inflation rates in the 1970s, it became important to incorporate the increased differentials of inflation rates (and hence of production costs) between countries and regions into measures of a country's price competitiveness — one such measure being the *real effective exchange rate* (see Box 1 for definitions of the terminology). Figure 1 illustrates the exchange rate experiences of three main groups of developing countries.

An upward movement in a country's real effective rate can arise from an appreciation of its nominal exchange rate, the depreciation of other countries' currencies, or a

### Box 1: Terminology

*nominal exchange rate*: the amount of domestic currency that can be bought with a unit of foreign currency.

*real exchange rate*: the nominal rate adjusted by the domestic country's inflation rate relative to the inflation rate of the respective foreign country.

*real effective exchange rate*: a weighted average of the country's real exchange rates with the currencies of important trading and investing partners. The weights are chosen to reflect the importance of each trading partner. (Similarly, the *nominal effective rate* is a weighted average of the country's nominal exchange rates).

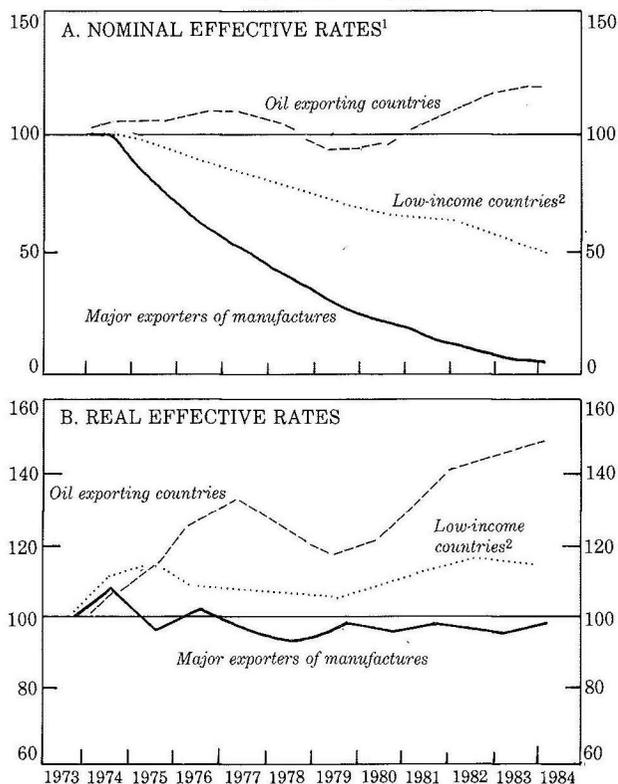
*multiple exchange rate system*: different rates are set depending on the type of transaction involved. Thus, for example, less domestic currency may be exchanged for a unit of foreign currency for the importation of "essential goods" (eg. inputs for export production) than for "non-essential" transactions (eg. imports of consumer luxuries, private financial transfers).

higher rate of domestic relative to foreign inflation. In the latter case, if it wishes to avoid the resultant loss of price competitiveness, the country must either attempt to reduce the domestic inflation rate, or alternatively, depreciate its currency to compensate for its relatively higher costs. Failure to make such corrections in order to restore international competitiveness leads to exchange rate *overvaluation*. However, a relatively high rate of inflation is not the only, or the most important, reason for an lDC to adjust its exchange rate. Policy makers may also seek to adjust the economy to movements in the international economy which are expected to have adverse effects on the balance of payments, for example a fall in real export earnings which is forecast to be of a non-temporary nature.

There is considerable debate among policy makers over the criteria to be used in assessing the appropriate level of a country's exchange rate. A common set of criteria applied by the multilateral agencies is that exchange rates should be set at a level which is conducive to the expansion of exports and contributes to a current account position which is both consistent with normal and expected capital flows over the medium term, and does not require management by extensive trade controls or a depressed level of economic activity. However, it is important to recognise that criteria other than those focusing on the balance of payments position may influence a country's exchange rate policy. In particular, factors such as a desire by governments to

**Figure 1: Exchange Rates in Developing Countries**

Indices 1973 = 100



Source: update of IMF World Economic Outlook 1983.

1. For definition of nominal and effective rates see Box 1.
2. Excluding China and India.

protect the real incomes of influential social groups from the effects of devaluation may dominate policy.

A large proportion of ldc have depreciated their nominal exchange rates as part of their adjustment programmes in the period since 1973. The largest real depreciations have on average occurred in the mid-1970s and since 1981 (Fig. 1). However, there are important differences between the major ldc groups in the use of exchange rate policy. Access to extensive *international commercial finance* allowed many of the major borrowers to maintain large current account deficits and to avoid significant exchange rate adjustment. Most of the major borrowers developed overvalued exchange rates from the late 1970s until early 1981 when significant depreciations to correct over-valuation began, for example, Argentina, Chile, Nigeria and the Philippines. Chile provides an example of the consequences of overvaluation — the fixing of the exchange rate in mid-1979, combined with continuing high inflation, led to an estimated 15 per cent rise in imports and a 5 per cent fall in exports by 1981.<sup>1</sup>

Middle-income countries with large earnings from oil (some of which were also large borrowers) permitted large real effective appreciations in the late 1970s and early 1980s (Fig. 1), for example, Venezuela and Indonesia. Likewise, some major producers of other minerals (eg. Zambia) used periods of high mineral prices in the early 1970s to allow large real appreciations. This exchange rate policy hindered the expansion of the non-mineral export base. Some of these countries have subsequently conducted correcting devaluations, eg. Indonesia in 1983.

Many ldc employ *trade and capital restrictions* to manage their current accounts as a partial or complete alternative to initiating adjustment programmes. The use of quantitative restrictions on imports is very prevalent in Africa, especially in the low-income countries which now

have limited access to further international credit. Although the average extent of overvaluation in Africa is now below the level of the early 1980s, for the period 1980-83, 11 out of 33 African countries in a recent survey still appreciated their real effective exchange rates by more than 10 per cent, with Tanzania and Sierra Leone showing the largest real appreciations of 77 and 53 per cent respectively.<sup>2</sup>

Overvaluation directs an economy away from foreign exchange earning activities. It can have particularly adverse effects on agriculture which is the economic base of most low-income ldc, since it can act as a disincentive to the production of both export crops and some food crops. Thus food imports in many countries have become cheaper than domestic output, resulting in increased food dependency (eg. Nigeria, Zambia, and Sri Lanka in the mid-1970s). Overvaluation has contributed strongly to the decline (in real terms) of prices paid to producers of export crops in many African countries. While most ldc have only limited control over the international price of their primary exports, an ldc can through its exchange rate policy affect the domestic currency equivalent of its exchange earnings. Allowing an appreciation of its currency reduces the amount available in domestic currency that can be paid to producers from the country's export earnings. For example, such reduced export incentives have been critical in undermining the production of cocoa in Ghana (the country's chief export earner) and causing the sharp fall of Tanzania's export production. In industry, overvaluation acts as a brake on the development of an export base and encourages a dependency on cheaper foreign supplies for inputs. In particular, cheaper capital imports encourage higher capital intensity, which may have adverse employment effects.

Ldc with overvalued exchange rates are also usually characterised by large illegal markets in foreign exchange which operate parallel to the official markets, and drain the latter of scarce foreign currency (eg. Tanzania, Burma). Official rationing of foreign exchange requires complex administration and results in above-normal profits for those with access to the limited foreign exchange licenses. The use of trade restrictions and the maintenance of an overvalued currency will only postpone action on the balance of payments problem and does not usually resolve the underlying causes of balance of payments difficulties.

## Devaluation

A significant number of major currency devaluations are conducted in the context of economic packages with financial support from the IMF and the World Bank (the latter through its structural adjustment loans), although devaluation is not invariably a condition for IMF support as is commonly assumed. In the 1973-81 period it was a policy condition in approximately 50% of Fund-supported programmes. The size of the currency depreciation is often a contentious issue — for example, in the recent negotiations between the IMF and both Argentina and Tanzania. The multilateral agencies generally favour a greater depreciation than the governments concerned. In low-income ldc an important reason for government reluctance to devalue substantially is that it would adversely affect a politically influential constituency, comprising urban beneficiaries of cheap food imports and those whose incomes are protected by trade controls. Eventually a very

1. G. Pfefferman: 'Overvalued exchange rates and development', *Finance and Development*, March 1985.
2. World Bank: *Towards Sustained Development in Sub-Saharan Africa: a Joint Program of Action*, Washington DC 1984 p.35.

## Box 2: Uganda's transition

From 1982 to mid-1984, Uganda operated a dual exchange rate system. This consisted of an exchange rate fixed by the central bank for official payments, export receipts and important import payments (the so-called 'Window 1'). A given allocation of foreign exchange was also auctioned weekly ('Window 2') to authorised dealers and the market rate determined was substantially below the Window 1 rate, and close to the rate prevailing in the black market. In this way, a substantial downward float of the shilling was managed, and the incentives for black market currency dealing substantially reduced. Although the administration of such multiple exchange rate systems is complex, and causes significant economic distortions if pursued over the long term, they may nevertheless be useful as a short-term device to depreciate a severely overvalued currency. An Auction System is also used in Jamaica.

large correcting depreciation is required, but this becomes politically more difficult the longer the overvaluation is allowed. Nevertheless some major depreciations have now taken place among African countries which had previously resisted the move, eg. Zaire in 1983, Ghana in 1983-84. The latter depreciation was partly achieved by using taxes on imports and subsidies to exports as a *fiscal proxy* for devaluation. Uganda's exchange rate adjustment is an interesting example of a policy which attempts to correct overvaluation through the use of transitional multiple exchange rates (see Box 2).

### Policy co-ordination

Exchange rate adjustment must be co-ordinated with, and supported by, other micro and macro-economic policies. Some temporary deflation via a tightening of the monetary and fiscal stance may be necessary to facilitate the transfer of resources from production for the home market to export production. Such deflation may in any case be required if an overexpansion of domestic demand in relation to domestic supply is an important contributor to balance of payments difficulties. Aside from such directly induced deflation, devaluation will in itself have an indirectly negative effect on real incomes through increases in import costs, raising the domestic price level. The size of this effect will partly depend on the importance of imports in relation to the total economy and the government's use of price controls. Another common criticism of devaluation as a policy instrument arises from the dependence of most ldc's on imported intermediate goods. Under such circumstances devaluation can result in both domestic cost-inflation and reduced economic activity (so-called 'stagflation'). In some cases these adverse effects can be severe, such as in the Chilean and Argentinian devaluations of the mid-1970s. Devaluation, through changes in the price level, will also affect the government's revenues and expenditures in real terms. Consistency between budgetary and exchange rate policies must be carefully controlled since devaluation can have important effects on the structure of government expenditures and revenues — through, for example, raising the domestic-currency cost of servicing foreign debt and affecting earnings from import duties.

Government policies towards producer prices may also

need adjustment. In those ldc's with state monopolies in the purchase of export crops, the prices paid to producers must be raised to reflect the exchange rate change. Direct government investment in export activities plus increased investment in infrastructure may be necessary particularly in the low-income countries.

### Effectiveness

The effectiveness of devaluation in contributing to the reduction of balance of payments deficits varies between ldc's, and largely depends on their level of development and the commitment of the government to support export activities. The balance of payments response to devaluation is typically quicker in the semi-industrialised ldc's than the lower-income ldc's, since the former group benefits from a greater diversification of the economic base, and thus greater possibilities of substitution between productive activities in order to expand both export production and import substitution. However, in some cases, especially in Latin America, the indirect deflationary effect of devaluation has led to a high cost (in terms of increasing unemployment) in achieving the balance of payments objective. The newly-industrialising countries of East and South East Asia have on average conducted continuing real depreciations, and this has contributed to their strong export performance: eg. Singapore and Malaysia. Some, for example South Korea in 1980, initiated substantial devaluations as part of their adjustment programmes and raised their already high rates of export growth.

The size and speed of the export response in ldc's dependent on primary products is subject to greater debate. Some crops (eg. coffee) and minerals have a long gestation lag before the investment yields additional output, and this will limit the size of the short-term export response. Critics of the efficacy of devaluation in low-income Africa argue that the potential of African smallholder producers to raise output is limited by the structural constraints of a low technological level, a heavy dependence on rainfed agriculture and low resource mobilisation. Thus the increase of producer prices to accompany devaluation must be co-ordinated with programmes to raise the productive ability of smallholders. In many African countries the rehabilitation of the transportation system is very important since difficulties in the collection of produce and in the distribution of inputs have constrained some recent attempts at cash crop expansion.

In a number of African countries (for example, Ghana, Tanzania and Zaire), the short term objective is to return to previous production levels of export crops and in principle this is possible provided that devaluation is supported by raising real producer prices, improving the availability of incentive goods in rural areas and mobilising sufficient external donor support. However, a major expansion beyond former output peaks and the further diversification into new export activities will in most cases require extensive external finance. Firm evidence is still awaited from those conducting major exchange rate reforms in Africa. For example in Ghana, the potential of the recent devaluations to raise export production has been set-back by bush fires. However, those African countries which avoided overvaluation, for example Botswana and Malawi, have on average maintained the growth of their export production. Evidence from low-income countries outside Africa also suggests that devaluation can in some cases contribute to the restoration of export growth if combined with sufficient external finance and other policy reform — for example the Sri Lankan adjustment, beginning in 1977.

**Table 1: Developing Countries:  
Exchange Rate Arrangements\***

(Number of countries)

	1978	1984
Pegged to a single currency	62	52
US dollar	41	33
Other currency	21	19
Pegged to a basket	28	35
SDR	15	11
Other composite	13	24
Flexible arrangements	23	39

\*IMF members only. Based on mid-year classifications.

Source: update of IMF *Annual Report 1984* Washington DC.

Finally, exchange rate adjustment by an individual ldc must be set in the context of both the policies being pursued by other countries and trends in world trade. The effectiveness of devaluation for a single country seeking to improve its export competitiveness may be reduced if the same policy is employed by other ldcs with similar export bases. International commodity agreements (such as that on coffee) set export quotas for individual countries, and this will limit attempts by an ldc seeking to raise its world market share. For other commodities, the expansion of primary exports simultaneously by ldcs can, without a concomitant increase in world demand, reduce international commodity prices and earnings. Expansion of industrial exports is also constrained by protectionism in developed countries, and may depend on preferential access to those markets.

### Current and future exchange rate arrangements

Ldcs have generally favoured a return to the Bretton Woods System of fixed exchange rates as a framework for the international monetary system, since these are perceived as giving greater certainty in trade and capital flows. However, there is little evidence that in the foreseeable future developed countries will be ready to subordinate their national policy objectives to the extent necessary to maintain an exchange rate system of the pre-1971 rigidity. Ldcs must adapt their policy accordingly.

Since the collapse of the fixed exchange system in 1971-73, there has been a fall in the number of ldcs maintaining a specific rate to a major currency — termed *pegging* (see Table 1). The choice of currency against which to peg was largely determined by the chief market for the ldcs' exports and the main source of their imports. (This was often the former colonial power.) The exception to this trend has been the continued importance of the Franc Zone, which incorporates 14 of the former French colonies of west and central Africa, as well as the French overseas departments, in a fixed exchange rate system tied to the French Franc. Under the fixed rate system, an ldc knew that pegging against one principal currency gave it stability against the other major currencies. Since in the present system the major currencies float, this policy has been

reconsidered by many ldcs — those ldc currencies pegged to the dollar have until recently appreciated with it (their real effective rates increasing by some 20 per cent over the 1980-83 period). Consequently, a substantial fall has occurred in the number of countries pegging to the US dollar.

As a consequence of the major fluctuations between the currencies of developed countries, the policy of pegging to a *composite basket* of major currencies has increased in popularity among ldcs (Table 1). Ldcs following this policy option have preferred to peg to a currency basket of their own choosing, and the number using the IMF's Special Drawing Rights (SDR) as their major currency basket has fallen. For the lower-income ldcs dependent on a small number of primary exports, the best policy may be to peg to a composite basket of major currencies and to conduct frequent adjustments to avoid loss of competitiveness. Small but frequent changes in exchange rates are usually politically easier to manage than large and infrequent devaluations, which cause large shifts in consumer price levels. The *crawling peg system* which has been mainly used in Latin America (eg. Brazil and Colombia) could be taken up by more ldcs, especially those in Africa. Under this system regular changes are made based on a predetermined formula to monitor the ldc's competitiveness relative to the rest of the world. Its benefits include the discipline of making systematic adjustments, although this system does not preclude large depreciations in response to major economic shocks. *Managed floating*, involving occasional government intervention in the exchange market, has increased among ldcs, but it is mainly conducted by the middle-income ldcs such as South Korea with diversified export bases and well developed foreign exchange markets.

The continuation into the immediate future of the float by major currencies will require a more active exchange rate policy in ldc's if they are to avoid unintended movements in the value of their currencies. However, controversy continues to surround the use of exchange rate adjustments as an active policy tool. Whilst it is generally effective in reducing balance of payments current account deficits, questions remain over the cost that is sometimes entailed, in terms of increased unemployment and inflation, and adverse changes in income distribution. If adjustments have to be made, the choice of policy instrument should ensure that the relatively poor should not bear an unequal share of the burden. Being an across-the-board instrument, devaluation alone does not necessarily meet this requirement.

©Overseas Development Institute, London 1985.

ISSN 0140-8682

*The Overseas Development Institute was incorporated in 1960 to promote study, discussion and exchange of information on economic and social development issues. It is a registered charity and is financed by official grants and private donations from British and international sources.*

*Briefing Papers present objective information on important development issues. Readers are encouraged to quote or reproduce material from them for their own publications but, as copyright holder, ODI requests due acknowledgement and a copy of the publication.*