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THE INTERNATIONAL MONETARY SYSTEM AND EXCHANGE RATE  
POLICIES IN THE DEVELOPING COUNTRIES

by

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IN THE DEVELOPING COUNTRIES

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Abstract

The paper reviews the proximate objectives the exchange rate regimes of developing countries may serve. These objectives include eschewing foreign exchange restrictions, maintaining realistic exchange rates, limiting uncertainty for business decision making, and reducing fluctuations in macroeconomic relationships.

It is concluded that, in many instances, these objectives can best be served by the adoption of freely-floating exchange rates. If this alternative is excluded, linking to a basket of currencies is superior to linking to a single currency, except if the latter is the currency in which the bulk of a country's trade is carried out. In the latter case, the requirements of macroeconomic and microeconomic stability may come into conflict.

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Introduction

The purpose of this paper is to evaluate the usefulness of alternative exchange rate systems for developing countries. The discussion will proceed on the assumption that the present international monetary system (or non-system) will continue to operate, so that developing countries will have to be prepared for substantial fluctuations in exchange rates -- in nominal as well as in real terms -- between the currencies of the major developed countries. Subsequently, the implications of removing this assumption will be briefly indicated.

Section I will review the proximate objectives the exchange rate regimes of developing countries may appropriately serve. These objectives include eschewing foreign exchange restrictions, maintaining realistic exchange rates, limiting uncertainty for business decision-making, and reducing fluctuations in macroeconomic relationships.

Section II will evaluate alternative exchange rate regimes from the point of view of the stated objectives on the assumption that the rate of inflation in the country concerned equals the trade-weighted average of inflation rates in its trading partners. Freely floating exchange rates, dual exchange rates, pegging to a particular currency, pegging to the SDR, and pegging to a trade-weighted basket will be considered in this section.

Section III will admit the possibility of differences in inflation rates in the country concerned and in its trading partners, on the average. It will further consider the question if the conclusions are affected in the

event of the transformation of the international monetary system. The principal alternative is the target zone system, which has attracted much attention recently.

I. Proximate Objectives of Exchange Rate Regimes in Developing Countries <sup>1/</sup>

Eschewing exchange restrictions may be considered as one of the objectives of exchange rate regimes in developing countries. Such restrictions introduce arbitrariness in the process of decision making and involve a cost to the national economy. This cost relates to the misallocation of resources as well as to rent seeking.

The efficient allocation of resources requires the free availability of foreign exchange to all users, with the market allocating foreign exchange among competing claimants. Under exchange restrictions, rationing by an administrative authority replaces rationing by the market. Rather than competition on the market, we have competition for the favors of the decision makers so as to obtain the rents inherent in the scarcity of foreign exchange.

Non-market allocation of foreign exchange is inefficient since the information dispersed among agents in the market is not available to an administrative authority, even if it wished to reproduce market processes. In practice, the authority will rely on rules of thumb and will respond to pressures on the part of users, when the outcome is influenced by the relative bargaining power of the participants, generally favoring large over small

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<sup>1/</sup> The word, "proximate" in the title of the section indicates that these objectives are designed to serve ultimate economic goals such as growth and employment. For an excellent discussion of the requirements of internal and external balance, see Black, 1976.

firms. Also, the process will often involve bribery so as to partake in the rent accruing to the recipients of foreign exchange.

Rent-seeking, too, involves economic costs. There is a cost involved in spending time and energy on obtaining foreign exchange from the administrative authority, rather than producing foreign exchange through exports and import substitution. Furthermore, to the extent that foreign exchange allocation is based on existing capacity (trading outlets in the case of consumer goods and production capacity in the case of inputs), competition for rents will involve the duplication of capacity (Krueger, 1974).

Exchange rate regimes should also aim at maintaining realistic exchange rates, defined as rates that ensure the attainment of balance-of-payments targets. An appropriate overall target for developing countries is the continuing inflow of foreign capital.

This target is predicated on the assumption that the marginal productivity of capital is higher in developing countries than the rate of interest they pay on foreign loans. For one thing, developing countries have a lower ratio of capital to labor than developed countries; for another thing, they can apply existing technology that has been originated in the developed countries.

The amount that may be borrowed is limited, however, by considerations of creditworthiness, which call for avoiding increases in the ratio of foreign debt to exports beyond certain limits. Once these limits are exceeded, there will be need to reduce the debt or, at the least, to reduce its ratio to exports. This, in turn, will necessitate financing interest payments, in full or in part, from export proceeds. Realism in exchange rates

will, then, require allowing for the foreign exchange needs of interest payments on the foreign debt.

Over- and under- valuation of the currency should thus be defined with respect to the concept of realistic exchange rates. At the same time, overvalued exchange rates distort the allocation of resources by discriminating against traded goods in favor of non-traded goods. They discourage exports and encourage imports, thereby giving rise to a balance-of-payments deficit over and above acceptable levels of foreign borrowing. As a result, pressures are generated to subsidize exports and to protect imports, which tend to create discrimination among trading activities, with attendant economic costs.

Undervalued exchange rates, too, have an economic cost. To utilize the expression introduced by Corden (1981), they involve "exchange rate protection" in discriminating against non-traded goods in favor of traded goods. As a result, a surplus is generated in the balance of payments that involves the misallocation of resources in investing in foreign financial assets, even though higher returns can be obtained in domestic investments. Furthermore, the upgrading of the country's export structure is hindered by reason of the fact that exports, in which the country is losing comparative advantage, continue to be profitable at undervalued exchange rates.

The unfavorable economic effects of overvaluation are well-documented in the development literature. They have been shown to have had an adverse impact on exports and, thereby, on economic growth in a wide variety of situations, ranging from the middle-income countries in Latin America (Balassa, Bueno, Kuczynski, and Simonsen, 1986) to the poor countries of sub-Saharan Africa (Balassa, 1984).

There is less experience with undervalued exchange rates in developing countries. Nevertheless, such a situation has arisen recently in the four East Asian NICs (Hong Kong, Korea, Singapore, and Taiwan), which have largely followed the U.S. dollar in depreciating their currencies vis-à-vis other trading partners in recent years. The result has been an increasing accumulation of reserves, transforming the four East Asian NICs (in particular, Korea and Taiwan) from borrowers to lenders in international financial markets, that conflicts with their well-conceived interests. (Balassa and Williamson, 1987)

There is further need to limit uncertainty for business decision making. The pursuit of this objective will require avoiding fluctuations in exchange values around what is considered a realistic level. Such fluctuations discourage exports due to the exchange rate risk. At the same time, continued fluctuations may mean that exporters expect a reversal of the situation in cases when a realistic exchange rate has been established.

In the face of exchange rate uncertainty, firms may also forego export-oriented investments and the establishment of trading facilities abroad. Furthermore, the losses suffered at the time of unfavorable exchange rates may not be fully reversible as market positions are lost and foreign buyers may permanently shift to other suppliers.

Mexico provides example of large fluctuations in currency values since 1982. In turn, Venezuela may be cited as a case where exporters did not expect the continuation of favorable exchange rates and the facts have proved them right. In December 1986, earnings derived from nontraditional exports were shifted from the free trade exchange market, where the rate was about 24 bolivars to the U.S. dollar, to the newly-established official rate of 14.5

belivars to the dollar, with only partial compensation provided through increased fiscal credit to exporters. In turn, stability in currency values had favorable effects in the East Asian NICs prior to 1985.

Finally, it is desirable to reduce fluctuations in macroeconomic relationships. Such fluctuations, associated with large variations in exchange rates, interfere with the conduct of economic policy in developing countries and require holding large foreign exchange reserves, which has a cost to the national economy.

## II. Alternative Exchange Rate Regimes for Developing Countries

In this section, alternative exchange rate regimes will be evaluated on the assumption that the rate of inflation in the country concerned equals the trade-weighted average of inflation rates in its trading partners. It will further be assumed that disparate changes occur in rates of inflation among individual trading partners.

Among possible alternatives, several authors had summarily dismissed freely floating exchange rates for developing countries by reference to the existence of limited capital markets, restrictions on capital flows, thin foreign exchange markets, and the lack of sufficient reserves to finance external shocks in these countries. <sup>2/</sup> In fact, until recently, there were practically no freely floating exchange rates in developing countries. This has changed, however, in the last several years.

Apart from Lebanon that has maintained a freely-floating exchange rate under adverse political conditions, Uruguay was the first developing country to adopt freely floating exchange rates, in the wake of its disastrous

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<sup>2/</sup> For review of the literature, the reader is referred to Williamson, 1985.

experience in attempting to use the exchange rate as an anti-inflationary device (see Section III below). It has been followed by Bolivia, the Dominican Republic, Gambia, Ghana, Guinea, Nigeria, the Philippines, Sierra Leone, Zaire, and Zambia, among which Ghana and Nigeria also have a preferential rate for debt-service payments and government transactions.

Why, then, the sudden popularity of floating exchange rates? Wickham (1985) questioned the validity of the proposition put forward in the literature as to the lack of suitability of freely floating exchange rates for developing countries. He also provided evidence from empirical studies that the choice of currency regimes does not depend on the level of economic development.

But, additional factors need to be introduced to explain the change in attitudes on the part of a number of developing country governments. Firstly, in countries where the rate is greatly overvalued, it is difficult to determine the appropriate (realistic) exchange rate. Secondly, governments, which are reluctant to undertake devaluations, can shift responsibility to the market for the depreciation of the currency. Thirdly, business can plan with the understanding that the exchange rate will not become overvalued again.

Freely floating exchange rates also offer advantages over dual exchange rates, which usually involve a lower rate for commercial, and a higher rate for financial, transactions. While dual exchange rates have generally been adopted with a view to avoid devaluations and/or reserve losses, they have led to the depreciation of the financial exchange rate. Differences between the two rates, in turn, involve discrimination among foreign exchange transactions, effectively taxing exports and the purchase of

foreign financial assets and subsidizing imports and the sale of foreign financial assets.

The maintenance of dual exchange rates also necessitates strict foreign exchange controls. Despite these controls, the underinvoicing of exports and overinvoicing of imports are widely practiced so as to exploit the profit opportunities offered by the exchange rate differential. These actions represent a capital outflow, and hence have an adverse effect on the balance of payments.

It was observed that in Belgium and France, which made use of dual exchange rates, a rate differential in excess of 5-10 percent gave rise to widespread evasion. This conclusion applies, a fortiori, to developing countries where the system of administration is weaker. At the same time, rate differentials in these countries have exceeded 100-200 percent in some cases. Such had been the case, for example, in Ecuador until August 1986 when the exchange rates applicable to private transactions were unified and the new exchange rate stabilized at about the mid-point between the two rates.

The use of freely floating rates also reduces reserve requirements under normal conditions. And while such reserves are needed in the event of external shocks, the financing of these shocks from foreign exchange reserves under a unified exchange rate regime permits to avoid that a temporary disturbance have real effects on the balance of payments and on the national economy. This will however be the case under dual exchange rates, where the ensuing depreciation of the financial exchange rate creates demand for non-traded goods by increasing the domestic currency value of foreign assets, thereby leading to the deterioration of the balance of payments (Kiguel and Lizondo, 1986).

Table 1

Exchange Rate Arrangements for Developing Countries  
(number of countries, as of January 31)

	<u>1979</u>	<u>1981</u>	<u>1983</u>	<u>1985</u>	<u>1987</u>
Pegged to a single currency					
US dollar	39	38	37	34	31
French franc	14	14	13	14	14
other currencies	7	4	5	4	5
total	60	56	55	52	50
Pegged to a basket					
SDR	12	15	15	11	10
trade weighted	15	18	18	25	24
total	27	33	33	36	34
Adjustment based on					
Set of indicators	4	3	4	5	5
Single currency			10	7	5
Other managed floating	2	23	14	15	17
Independently floating			3	6	12
total	24	26	31	33	39
Grand Total	111	115	119	122	123

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Source: International Monetary Fund, International Financial Statistics, various issues.

Alternative exchange rate arrangements include pegging to a single currency, to the SDR, or to some other currency basket. In January 1987, 31 developing countries pegged their currencies to the U.S. dollar, 14 to the French franc, 5 to other currencies, 10 to the SDR, and 24 to other currency baskets. As shown in Table 1, these numbers represent a decline over time in the number of currencies pegged to the US dollar and, to a lesser extent, to the SDR, as well as an increase in pegging to a currency basket based on trade weights. <sup>3/</sup>

Pegging to a single currency offers advantages in part because the currency in question is also employed as an intervention currency and in part because business firms use it as a vehicle currency in which to invoice, to cover forward transactions in other currencies, to borrow, and to lend (Williamson, 1987). It has also been shown that Latin American countries whose currencies were pegged to the U.S. dollar experienced substantially less inflation than other countries of the region and the same result has been obtained in regard to countries of the Franc zone (CFA) as against other African countries (Connolly, 1985). Furthermore, Patrick Guillaumont (1986) explains the greater openness of the CFA countries, in terms of their participation in international trade, by the stability of exchange rates and the convertibility of their currencies.

Fluctuations in the value of the currency, to which a particular exchange rate is pegged, will matter little as long as it accounts for the bulk of foreign exchange transactions for the country concerned. This has

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<sup>3/</sup> Dual exchange rates are not shown separately in the statistics. However, Table 1 includes currencies that are neither freely floating nor pegged.

been the case for the CFA countries, even if one excludes other member countries of the EMS. It has been less so for countries that link their currencies to the U.S. dollar. Thus, in 1976, France had a 39 percent share in the trade of the CFA countries, on the average, with these shares varying from 30 to 49 percent, whereas the corresponding average for trade with the United States was 24 percent for countries whose currencies were pegged to the US dollar, with these shares ranging from 1 to 85 percent (Brodsky and Sampson, 1984). Also, the dollar has shown larger fluctuations in effective terms than the French franc, even though several parity changes occurred within the EMS.

As a result, the currencies linked to the U.S. dollar have experienced considerable fluctuations over time with respect to other currencies, with an appreciation being followed by a depreciation in trade-weighted (effective) terms. A case of point is Hong Kong whose effective exchange rate appreciated by 14 percent between October 1983, when its currency was linked to the U.S. dollar, and September 1985, the date of the Plaza Agreement, and depreciated by 29 percent between September 1985 and April 1987 (Balassa and Williamson, 1987). <sup>4/</sup>

Linking to a fluctuating single currency also gives rise to macroeconomic shocks. There are further adverse microeconomic effects as fluctuations in exchange rates create uncertainty for business decisions and

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<sup>4/</sup> At the same time, pegging to the U.S. dollar has been often in name but not in reality. Thus, among the 31 currencies listed in Table 1 as being dollar-pegged on January 31, 1987, only 9 maintained their value in terms of dollars between 1973 and 1986 (the group includes the People's Democratic Republic of Yemen that has less than 2 percent of its trade with the United States but has nevertheless chosen to maintain a constant relationship with the US dollar).

over- or under- valuation with respect to other currencies affects the country's competitiveness.

It has been shown that, compared with pegging to a single currency, pegging to the 16-currency basket SDR would have generally led to less instability in the effective exchange rates of the developing countries. The exceptions are pegging the currencies of some Caribbean countries to the U.S. dollar and pegging CFA currencies to the French franc (Helleiner, 1981; Brodsky and Sampson, 1984).

The SDR has since been transformed into a basket of only 5 currencies, thereby reducing its compensatory properties as far as exchange rate fluctuations are concerned, according to the law of large numbers. Nevertheless, the 5-currency peg performed better in relation to the effective exchange rate than the 16-currency peg in the case of Jordan in the 1975-83 period. For the same country, linking to the U.S. dollar was shown to be superior to the SDR link in the first part of the period while the opposite conclusion applied in the second part as well as for the period as a whole (Takagi, 1984).

But, even though the SDR peg better approximates the trade-weighted average of exchange rates than the single currency peg, it still remains an imperfect approximation to the former. Thus, a more appropriate solution is to use a trade-weighted peg, including merchandise trade as well as service transactions in the calculations. The choice of this alternative makes it possible to minimize the macroeconomic effects of external shocks, reducing uncertainty for traders, and to limit the extent of over- and under- valuation of the currency.

Table 2: Trade-Weighted Averages of Standard Deviations of Exchange Rates in Bilateral Relationships, 1970-86

	Nominal Exchange Rates		Real Exchange Rates	
	Actual Rate	Trade-Weighted Rate	Actual Rate	Trade-Weighted Rate
Benin	5.535	5.579	n.a.	n.a.
Burkina Faso	2.996	3.850	8.75	8.26
Cameroon	3.524	3.900	4.75	5.06
Central Africa	3.046	3.926	4.22	3.85
Congo	4.198	4.822	6.07	5.81
Cote d' Ivoire	4.583	5.008	7.38	6.86
Gabon	6.145	8.642	8.39	7.97
Mali	2.005	2.730	n.a.	n.a.
Niger	3.917	6.091	8.41	8.16
Senegal	3.219	4.378	7.50	6.81
Chad	3.728	4.437	n.a.	n.a.
Togo	4.644	4.774	7.14	7.04
Egypt	23.661	6.650	24.88	7.12
El Salvador	28.699	7.705	8.01	7.19
Ethiopia	8.623	7.187	10.11	9.87
Guatemala	7.423	8.709	7.54	8.06
Haiti	3.720	4.967	6.76	6.56
Honduras	4.948	6.246	5.19	5.37
Iraq	12.367	9.871	n.a.	n.a.
Liberia	8.613	6.078	7.63	6.75
Nicaragua	55.249	8.426	n.a.	n.a.
Oman	11.674	6.528	n.a.	n.a.
Panama	6.100	7.610	5.88	6.98
Paraguay	18.743	22.487	15.96	22.25
Peru	53.016	9.922	14.41	19.36
Syria	10.906	6.829	n.a.	n.a.
Trinidad & Tobago	13.106	3.706	7.27	5.68
Venezuela	15.606	5.411	13.66	4.85
Vietnam	349.725	6.172	n.a.	n.a.
Yemen, Arab Republic	11.291	6.182	n.a.	n.a.
Yemen, P.D.	7.734	6.324	n.a.	n.a.

Source: World Bank data base.

At the same time, there are no technical obstacles to the use of a single intervention currency while employing a trade-weighted average to determine currency values (Takagi, 1986). Also, exporters (importers) may utilize several vehicle currencies, depending on where they export to (import from), and may engage in forward market transactions in these currencies. <sup>5/</sup>

Nevertheless, as first noted by Sylviane Guillaumont (1984), there may be a conflict between the requirements of macroeconomic and microeconomic stability. Thus, the trade-weighted average of the standard deviation of bilateral exchange rates may be greater if the rate is set so as to eliminate fluctuations in the trade-weighted (effective) exchange rate than if it is set in terms of the currency that accounts for the bulk of a country's trade. <sup>6/</sup>

This hypothesis has been confirmed by calculations made by Paraire (1987) for the 1970-83 period in the case of all but one of the currencies of the Franc zone, the exception being Togo. It has been confirmed without exception if the real (inflation-adjusted) exchange rate is utilized.

The present author has redone the calculations for the countries of the Franc zone for the 1970-86 period. His results are the same as those of Paraire using nominal exchange rates but are inverted in all cases except one

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<sup>5/</sup> A trade-weighted basket is customarily defined in terms of the composition of a country's exports and imports. An alternative procedure involves setting currency values on the basis of changes in the currencies of the country's competitors. While in the first case one considers substitution against the products of trading partners, in the second case substitution against the products of competitors is considered. The choice between the two alternatives should depend on the relative importance of these substitution relationships for the country concerned. One may also choose an intermediate solution by taking, for example, some average of the two weighting schemes.

<sup>6/</sup> A similar argument is made by Williamson (1987).

using real exchange rates (Table 2). At the same time, from the point of view of evaluating exchange rate systems real rather than nominal exchange rates are relevant.

Calculations have further been made for the currencies of countries linked to the U.S. dollar, whose population exceeds one million. Sylviane Guillaumont's hypothesis is confirmed in five out of nineteen cases using nominal exchange rates and five out of twelve cases using real exchange rates.

Thus, while macroeconomic instability is minimized through the adoption of trade-weighted exchange rates, the objective of microeconomic efficiency may be better served if the country's currency is linked to that of its principal trading partner. The results are not conclusive, however.

### III. Exchange Rates Regimes for Developing Countries under Alternative Assumptions

If developing countries link money creation to the balance of payments, their inflation rates will approximate inflation rates in the country (countries) to whose currency their exchange rate is pegged. Such has been the case, in fact, in the Caribbean and the CFA countries referred to earlier.

In the absence of a link between money creation and the balance of payments, inflation rates may differ among the countries concerned. It has been claimed, however, that maintaining the peg will eliminate differences in inflation rates. The basis of this proposition is the so-called law of one-price. As Sjaastad expressed it:

"For an economy in which all goods are traded internationally, it is widely held that the internal rate of inflation is determined by the external inflation and changes in the exchange rate. This proposition is merely an extension of the 'law of one price.' To the extent that this law holds at every moment in time, the price level is completely

determined, as is its rate of change. In such an economy, exchange rate policy is obviously sufficient to determine the rate of inflation, and there can be little question concerning the efficacy of that policy as a stabilization tool" (Sjaastad, 1984, p. 85).

Sjaastad admits that "the presence of 'home' or nontraded goods complicates the analysis, as the exchange rate can affect the price of these goods only indirectly - through substitution effects, through expectations, or through both" (Ibid.). But, he adds:

"The general idea is that -- under normal assumptions concerning preferences and production possibilities, and given the state of overall demand relative to production -- there is but one price of home goods, relative to that of traded goods, which will clear the home goods market. Letting the nominal internal price of traded goods be determined by external prices and the exchange rate, this determines the equilibrium nominal price for home goods, and hence the equilibrium price level" (Ibid.).

To examine the validity of this proposition, one needs to consider the process of adjustment in regard to standardized and differential products in the traded goods sector as well as in regard to nontraded goods. The answer is simple in regard to standardized commodities: for importables, the domestic price will equal the international price plus transportation costs and the tariff while for exportables the domestic price will be the international price less transportation costs. The law of one price will hold in this case, the adjustment period will be short, and -- once adjustment is made -- the rate of increase of domestic prices cannot differ from that of international prices.

Such will not be the case for differentiated traded goods which dominate the manufacturing sector, including practically all consumer goods and investment goods as well as a substantial proportion of intermediate products. For these commodities, the relationship between domestic and international prices will depend on the elasticity of substitution between the

domestic and the foreign varieties of the product, in home markets for importables and in foreign markets for exportables. Correspondingly, prices -- and their rates of increase -- may diverge for a protracted period.

This conclusion applies a fortiori to nontraded goods. There is no microeconomic mechanism that would equalize the prices of these goods, or their rates of change. In turn, macroeconomic mechanisms act but slowly through changes in overall demand conditions.

The exchange rate was used as an anti-inflationary device in the Southern Cone of Latin America (Argentina, Chile, and Uruguay) during the early 1980s. The following discussion concerns the experience of Chile, where the exchange rate was maintained fixed in terms of the U.S. dollar between June 1979 and March 1982.

The divergence in the rate of increase of domestic and foreign prices declined only slowly in Chile and the divergence in the rate of increase of the domestic prices of non-traded and trade goods failed to decline (Balassa, 1985). This is hardly surprising, given low product substitution elasticities in production and consumption in the short run and even in the medium run, particularly between traded and non-traded goods.

In the presence of sluggish adjustment in prices, then, using the exchange rate as an instrument to reduce the rate of inflation imposes a real cost on the economy. And, the appreciation of the exchange rate in real terms is not undone at the time when domestic and foreign prices converge, so that the overvaluation of the exchange rate is perpetuated.

At the same time, the loss in export market positions may involve an element of irreversibility, as consumers shift to other suppliers. Also, as

domestic producers are unable to compete with imports, the customary historical process of traders becoming producers may be reversed.

These considerations point to the inappropriateness of using the exchange rate as an anti-inflationary device. Rather, the exchange rate should be adjusted in line with the domestic-foreign inflation differential. This means maintaining the real effective exchange rate, rather than the nominal effective exchange rate, constant over time, barring permanent shifts in the underlying conditions.

Temporary shifts in the balance of payments, in turn, should be accommodated through changes in foreign exchange reserves and/or in the external debt. It would further be desirable to make increased use of the IMF Compensatory Financing Facility, designed to compensate for fluctuations in export receipts, and to establish an interest equalization scheme, to compensate for fluctuations in interest rates (Balassa, Bueno, Kuczynski, and Simonsen 1986).

The question remains if the above conclusions need to be modified in the event that variations in the values of the currencies of the major developed countries are reduced through e.g. the establishment of a target zone. The economic cost of pegging to a single currency will be lower in this case but the use of a trade-weighted basket will continue to offer advantages.

For one thing, differing rates of inflation in different industrial countries will lead to changes in the target zones of their currencies. For another thing, account needs to be taken of fluctuations in currency values among developing countries that are trading partners or competitors for the country in question.

## Conclusions

This paper has suggested that alternative exchange rate regimes be evaluated by reference to the objectives of eschewing foreign exchange restrictions, maintaining realistic exchange rates, limiting uncertainty for business decision making, and reducing fluctuations in macroeconomic relationships. In view of these objectives, freely floating exchange rates appear superior to other alternatives.

If the adoption of a freely-floating exchange rate was excluded, linking to a basket of currencies is superior to linking to a single currency, except if the latter is the currency in which the bulk of a country's trade is carried out. In the second eventuality, the requirements of macroeconomic and microeconomic stability may come into conflict.

Reductions in United States trade shares and fluctuations in the value of dollar may explain the decline over time in the number of currencies pegged to the U.S. dollar. These considerations apply, a fortiori, to the British pound, to which a number of currencies were pegged in the early postwar period, four currencies as late as 1979, and none in 1987. The desirability of avoiding fluctuations of currency values in effective terms also points to the superiority of trade-weighted exchange rates over pegging to the SDR, which is manifested in the shift from the latter to the former.

7/ At the same time, there has been an increase over time in the number of freely floating rates.

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7/ At any rate, the reported figures overstate the number of currencies that are de facto pegged to the US dollar or the SDR. Thus, there are currencies "whose value for all intents and purposes was defined independently of the currency to which it ostensibly pegged" (Brodsky and Sampson, 1984, p. 141). In 1979, there were 17 such currencies out of 39 ostensibly pegged to the U.S. dollar and 10 out of 12 currencies ostensibly pegged to the SDR, leaving Guinea and Jordan as the only "true" SDR peggers (Ibid., pp. 139-41).

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