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THE EVOLUTION OF LATIN AMERICAN  
EXCHANGE-RATE POLICIES  
SINCE WORLD WAR II

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS AND SOCIOLOGY

PRINCETON UNIVERSITY

Princeton, New Jersey

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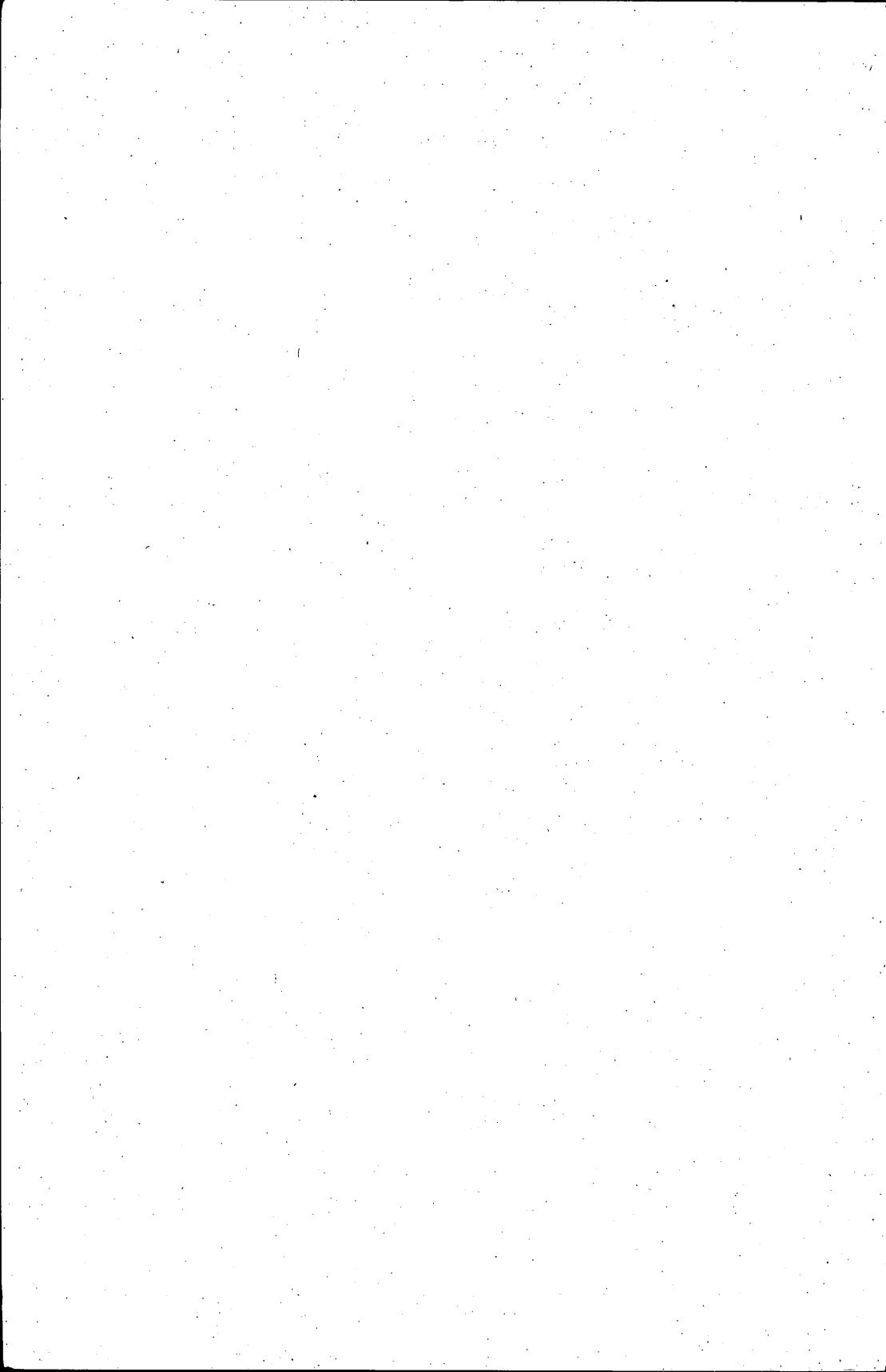


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# THE EVOLUTION OF LATIN AMERICAN EXCHANGE-RATE POLICIES SINCE WORLD WAR II\*

LATIN American countries have long been a laboratory of different exchange-rate techniques. Their exchange authorities have employed widely varied and complex exchange-rate devices in controlling their international payments. What is not generally appreciated, however, is the extent to which these systems are in a state of flux with regard to both effective rates and the type of rate system employed.

Over the years, it is also possible to discern broad trends in the exchange-rate policies of the area as a whole. These similarities are perhaps attributable to the fact that experience with a superior rate system in one country tends to be taken into account by others when they decide on changes in their own systems. An even more important factor making for such similarities, however, is the frequent parallelism of economic and institutional circumstances influencing the policy makers of the various countries.

This paper traces two broad trends in Latin American exchange-rate policies since World War II—a pronounced and widespread trend toward an increased use of flexible exchange rates, and a more gradual trend toward the simplification of previously highly complex rate systems. The reasons for these trends will be analyzed in terms of the conflicts of economic policy objectives and management difficulties of the earlier systems that have shown up during the postwar period. Finally, some possible broader implications of the Latin American experience for future exchange-rate policies in the world in general will be suggested.

## I. EVIDENCE OF THE TRENDS

Table I is designed to show the main outline of the trends in the exchange-rate systems used by the Latin American republics in the years 1947-1957. Only the broader varieties of Latin American exchange-rate systems are described in the left-hand column of the table. The finer

\* The author is grateful for the helpful comments of H. L. Sanford, M. N. Trued, and J. Levin.

TABLE I

Latin American Exchange-Rate Systems, 1947-1957<sup>a</sup>

<i>Categories of Rate Systems</i>	<i>End of 1947</i>	<i>End of 1952</i>	<i>End of 1957</i>
1. Single fixed rate	Cuba Dominican Republic El Salvador Guatemala Haiti Honduras Mexico	Cuba Dominican Republic El Salvador Guatemala Haiti Honduras Mexico	Cuba Dominican Republic El Salvador Guatemala Haiti Honduras Mexico
2. Fixed multiple rates	Bolivia Brazil Colombia Uruguay Venezuela	Brazil Venezuela	Venezuela
3. Fixed multiple rates for trade transactions; fluctuating rate for financial transactions.	Argentina Chile Costa Rica Nicaragua	Bolivia Nicaragua Paraguay Uruguay	Nicaragua Uruguay
4. Mixed multiple fixed rates and fluctuating rates for trade transactions; fluctuating rate for financial transactions.	Ecuador Paraguay Peru	Argentina Chile Colombia Costa Rica Ecuador	Argentina Brazil Colombia Costa Rica Ecuador
5. Single fluctuating rate for trade transactions; fluctuating rate for financial transactions.		Peru	Chile Peru
6. Single fluctuating rate			Bolivia Paraguay

<sup>a</sup> The Table covers all Latin American republics except Panama, which has been omitted because the bulk of the Panamanian money supply consists of United States notes and coins.

NOTE: In the classification of a vast variety of exchange-rate systems into a few categories, some difficult choices had to be made in borderline cases. For example, exchange-rate discrimination between different international transactions was very limited in Brazil in 1947 and 1952, consisting mainly of a small surtax on the selling rate for all but "essential" payments. Hence, the country might have been classified under category 1 rather than 2 at those dates. In another such

case, Colombia was operating with fluctuating (but multiple) rates for a 9-month period including the end of 1957; fixed rates for some transactions were reinstated in early 1958. This case might have been covered by the inclusion of another category—between 4 and 5—in the Table.

SOURCES: International Monetary Fund, *International Financial Statistics*, 1948-1958, various issues; and *Annual Report on Exchange Restrictions*, 1950-1958, various issues.

differentiations—such as whether the multiple rates applied only to exports, or only to imports, or to both—are left out of account. Furthermore, the table does not escape a certain arbitrariness typical of most classifications. Thus, it may be questioned whether it is appropriate to place various Central American countries and Mexico in the same category of “single fixed rate,” given the fact that most of the Central American countries have had the same exchange rate throughout the postwar period while Mexico devalued its exchange rate (in several steps) by over 60 percent between 1947 and 1957.\* (Some additional qualifications are given in the note to the table).

Despite these qualifications, the table does demonstrate that, with the exception of most of the smaller countries in Central America and the Caribbean, there has been a fairly steady trend among the Latin American countries toward an increased use of flexible exchange rates, as well as a gradual trend toward more simplified rate systems. In terms of the table, the countries accounting for the bulk of Latin America's trade and payments have moved “southeastward.” Thus, Brazil moved from category 2 at the end of 1952 to category 4 in 1957; Chile from 3 to 4 between 1947 and 1952, and then to 5 by the end of 1957; Colombia from 2 to 4 between 1947 and 1952; and Argentina from 3 to 4 between 1947 and 1952. The reverse “northeasterly” movement has been virtually unknown, but there are a few countries (even aside from those with a single fixed rate throughout the period) that have not made a change in the type of rate system used—e.g., Nicaragua and Venezuela.†

The second of the trends mentioned above—that toward more simplified rate systems—is not as obvious in the table as is the first; nor is it as easy to define conceptually. While it may be accepted readily that countries moving from categories 2 to 4 into categories 5 and 6 have

\* The par value of the Mexican peso stood at \$0.20597 at the end of 1947 and at \$0.08 at the end of 1957. In further contrast with the other countries in the same group of the table, Mexico actually operated with a fluctuating exchange rate for some months of the postwar period (1948-1949).

† An examination of the rate systems applicable at dates intermediate to those given in the table would not change the results. The shifts would of course be more gradual than those shown at five-year intervals.

simplified their rate systems, such cases have not been very frequent. The greater number of changes has been from categories 2 and 3 into categories 3 and 4, and it is evident that to add one or more fluctuating rates for selected trade and/or financial transactions to an earlier system of fixed multiple rates does not necessarily simplify the system as a whole.\*

An accurate measure of the relative complexity of various exchange-rate systems should probably take into account not only the *number* of effective rates applicable to a country's exchange transactions, but also the *volume of transactions* taking place at each rate. For example, it might (and should) be asked which is more complex: a rate system with four effective rates, in which one particular rate applies to 95 percent of total exchange transactions; or a rate system with three effective rates, in which one-third of the exchange transactions take place at each of the rates? Though there are no simple answers to questions of this type, the principal emphasis in this paper will be on the number of effective exchange rates. Thus, countries reducing the total number of their exchange rates will be presumed to have simplified their rate systems. In citing instances, however, we shall ignore rate simplifications that represent wholly or mainly an abolition of purely nominal rates and concentrate on cases in which rate consolidations actually resulted in fewer rates for the bulk of a country's international transactions.

## II. REASONS FOR THE TRENDS AND THE EXPERIENCE UNDER VARIOUS EXCHANGE-RATE SYSTEMS

Multiple and fluctuating exchange rates have been analyzed frequently, if not exhaustively, in recent years.† Most of the discussions, however, have been in terms of the advantages and disadvantages of particular rate schemes *per se*, or in terms of comparisons between various possible rate schemes. The factors accounting for changes from one rate system to another have been treated less fully. For expository purposes, the following explanation of the trends in Latin American exchange-rate policies will also run in terms of individual (or groups of)

\* As will be noted in more detail later, the immediate effect of such changes has usually been to increase rather than reduce the complexity of the rate system, and it was only later partially offset by consolidations of the effective rates into fewer groups.

† The standard references for multiple exchange rates are E. M. Bernstein, "Some Economic Aspects of Multiple Exchange Rates," *International Monetary Fund Staff Papers*, September 1950, pp. 224-237; and E. R. Schlesinger, "Multiple Exchange Rates and Economic Development," *Princeton Studies in International Finance*, No. 2, Princeton 1952. Both multiple and fluctuating rates are discussed in R. F. Mikesell, *Foreign Exchange in the Postwar World*, New York 1954, especially Chapter 19.



rate schemes. The major emphasis, however, will be placed on the reasons for the observed trends through the various stages or categories of rate systems. The presentation is designed to show the factors behind the passing through (or remaining in) the various intermediate stages between fixed multiple rates and a single fluctuating rate, instead of the possible alternative of changing from one of these rate systems to the other in one step.

## I. DECLINE OF FIXED MULTIPLE-RATE SYSTEMS

### *Objectives of Fixed Multiple Rates*

The objectives of fixed and multiple rates have been many and varied. Only a brief summary of the most frequent types of reasoning in support of such systems will be offered at this point; a fuller discussion of the interrelations and conflicts among these objectives will come later.

- (a) Penalty selling rates of exchange for selected transactions permit a necessary reduction in exchange expenditures to be concentrated upon those goods and services for which the home demand is relatively elastic, so that a moderate devaluation of the average of all selling rates will reduce the demand for exchange substantially.\* Partial devaluation may, therefore, serve as a substitute for the imposing or tightening of quantitative import restrictions.
- (b) Preferential selling rates of exchange for selected imports permit a lessening of the impact of devaluation upon the domestic price level by avoiding (or minimizing) the devaluation of those rates that apply to "essential" items of mass consumption.
- (c) Penalty buying rates for selected exports enable the authorities to exempt exports with a relatively inelastic supply from a devaluation of the average buying rate. Thus, the authorities may avoid generating windfall profits for the exporters of such goods

\*The terms "selling" and "buying" rate of exchange are used here as they apply to exchange transactions from the point of view of the exchange authorities and of authorized exchange dealers (including commercial banks). Such institutions and individuals *sell* exchange to *importers* and other users of exchange, while they *buy* exchange from *exporters* and other suppliers of exchange. (These definitions are in accord with International Monetary Fund terminology.)

A penalty selling rate of exchange is one that exceeds the average selling rate in terms of local currency per unit of foreign currency, while a preferential selling rate is one that is below the average selling rate. Correspondingly, a penalty buying rate is one below the average buying rate, and a preferential rate is one above that average rate. (These definitions, which follow economic rather than legal criteria, are the ones used by E. M. Bernstein, *op.cit.*, p. 232.) The relevant averages are of course weighted (and not simple) arithmetic averages of the effective exchange rates.

and hold in check their demand for local and imported goods and services. Furthermore, where a country is a non-atomistic supplier of an export commodity, the incidence of the tax implicit in a penalty rate for the commodity may fall at least in part upon the foreign customer.\*

- (d) Preferential buying rates for selected exports assist those exporters who are hardest pressed competitively and may help to lessen dependence on one or a very few export commodities by stimulating new types of exports.†
- (e) Maintaining fixed though multiple rates rather than one or more fluctuating rates preserves most of the basic advantage of a single fixed rate, namely, the relatively smaller risk of future exchange-rate changes in a fixed- as against a fluctuating-rate system.
- (f) A substantial spread between the average buying and selling rates of a multiple-rate system provides a good source of government revenue.

Why are these arguments no longer as convincing to the authorities of many of the Latin American countries as they were a decade ago? In all likelihood, the two main parts of the answer to this question must be sought in the accumulation of substantial experience with the enormous difficulties of administering fixed exchange rates under persistent large-scale inflation; and in a gradual recognition of the fact that the administrative matching of specific commodity groups and specific rates under multiple-rate systems involves very difficult choices between conflicting policy objectives—choices so difficult, indeed, that the gains in terms of attaining any one of them have often been more than offset by the gains forgone in other directions.

#### *Fixed Multiple Rates and Inflation*

The persistence of large-scale inflation in all the larger Latin American countries has been one of the principal characteristics of the area throughout the postwar period.‡ Much could be said about the relative

\* Some of the relatively rare cases in which a Latin American country holds a monopolistic or oligopolistic position in an export market will be mentioned later. The corresponding theoretical case on the import side is left out of account because all Latin American countries, taken individually, are atomistic buyers in world markets.

† It is assumed in this argument that the granting of preferential rates for selected exports (i.e., devaluation of the applicable exchange rate) will not result in a significant lowering of the foreign-currency price of these exports. Thus, it applies only in those cases in which a country is an atomistic supplier of the commodities in question. Most Latin American countries, however, do occupy such a position in world markets for the vast majority of their export products.

‡ Inflation has of course been one of the major economic problems in practically all areas of the world throughout much of the postwar period. In many Latin Ameri-

importance and interaction of the major contributing factors—the addition of “modern” types of government capital expenditures for development projects to the “traditional” large outlays for military and social welfare schemes; the continued institutional and administrative weaknesses in tax policy and revenue collection; the demands of rising industries for liberal credit policies; the increased power of organized labor in many of the countries; and the lag of voluntary savings, which is in part a consequence of inflation itself. At the moment, however, our interest centers upon persistent inflation as a practical problem for exchange-rate policy.

In this connection, the main point is that persistent inflation has invariably led to or accentuated an overvaluation of the existing fixed rates, even if these had been appropriate at sometime in the past. Thus, although the assignment of only a relatively few commodities and types of exchange transactions to the “minor” (i.e., more depreciated) rates might initially have sufficed to restore equilibrium in the balance of payments if the excess demand for exchange arising from domestic inflation had been curbed, the failure to curb inflation led sooner or later to renewed pressures on international reserves. The typical first reaction to a loss of reserves took the form of one or both of the following: reimposition or tightening of quantitative restrictions on exchange transactions, or transfer of additional commodities and types of exchange transactions into the “minor”-rate categories.\*

Both of these measures, it will be noted, amount to an admission of defeat in terms of several of the above-enumerated objectives of fixed multiple-rate systems. Where quantitative restrictions were renewed or intensified, for example, multiple rates were not in fact a substitute for administrative allocation of exchange; and where commodity reclassifications were undertaken, the stability of the exchange-rate structure on the pivot of the “basic” rate was not preserved. Even more important,

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can countries, however, the inflations of the past decade have far exceeded in virulence and continuity those experienced in other parts of the world. (Comparative data on price and money-supply increases in a large number of countries over the postwar years can be found in the International Monetary Fund's monthly *International Financial Statistics*.)

\* These, as well as subsequent statements relating to historical developments in postwar Latin American exchange-rate policies, are in part a synthesis of voluminous material from individual country sources, which will not be cited here because of their specialized nature. Two major sources covering the broad outlines of exchange-rate policies and regulations in all or most Latin American countries are the International Monetary Fund's *Annual Report on Exchange Restrictions* (since 1950); and the First National City Bank of New York's *Summary . . . Exchange and Foreign Trade Regulations* (annually since 1943).

however, these measures raised additional serious difficulties, with the quantitative restrictions in particular proving unworkable in country after country.

The Latin American experience of the past decade well illustrates the high correlation between the degree of overvaluation of an exchange-rate system and the difficulty of administering the quantitative exchange restrictions associated with it. Thus, so long as the excess demand for foreign exchange that cannot be satisfied from current exchange resources is relatively small—say, 5 to 10 percent—reasonably nondiscriminatory criteria for the allocation of exchange may be found.\* The continuation of inflation along with the existing exchange-rate structure, however, gives rise to insurmountable problems. The gap between exchange resources and the demand for exchange widens as rising internal prices together with rising money incomes broaden the range of potentially importable goods, while exportable goods are increasingly diverted to the home market, or produced in reduced volume, or both.† Large windfall profits can be reaped by the recipients of import licenses since internal price controls cannot be made effective, at best, for more than a few staple commodities. These profits in turn provide the leverage for extensive illegal connivance between importers and the administrators of exchange-control machinery. Finally, faced with intense pressures for larger exchange allocations, there is an almost irresistible temptation for the exchange authorities to overestimate future exchange availabilities and to issue licenses in excessive volume. Thus, a state of complete disorder in the international payments of the countries con-

\* It will be understood that difficult problems arise in the measurement of these quantitative relationships. Thus, the term "current exchange resources" should probably be defined to include not only actual exchange purchased by the authorities (and authorized dealers) during a given period, but also such reductions in the country's official exchange reserves as may be compatible with a clearly foreseeable future increase in export prices, the seasonal pattern of exports, etc. In measuring demand for exchange, on the other hand, actual requests for exchange during a given period represent only one of the relevant factors. Suppressed demand for exchange associated with import restrictions so severe that they cannot be maintained for long, as well as other factors making for predictable increases or declines in the demand for exchange, should also be taken into account.

† The relative likelihood of these two possibilities depends to a considerable extent on whether or not the principal export goods are also important items of home consumption. Where this is the case, the rise in money incomes and the gradual increase in the degree of overvaluation of the applicable exchange rate will be associated primarily with a diversion of exports to the home market. Where the principal exports are not consumed in volume at home (and the income elasticity of demand for these goods is low), the combination of rising costs and fixed exchange rates will express itself primarily in reduced production, the extent of the reduction depending upon the elasticity of the supply. The structure of exports and home demand in most Latin American countries is such that the second case is more likely than the first. It will be understood, however, that the two cases are not mutually exclusive. Both effects may therefore occur simultaneously.

cerned has frequently been the end result of fixed multiple rates and persistent inflation.\*

The unsettling effects of frequent commodity reclassifications within a system of fixed multiple rates need not be labored. To some extent, such reclassifications are an alternative to quantitative restrictions and thus provide welcome relief to the administrators of these restrictions. On the other hand, they amount to a step-by-step devaluation. Thus, all the disadvantages of a "pre-devaluation atmosphere"—anticipatory price increases, the withholding of previously imported and of exportable goods from the market, and the prevalence of other types of speculative activity—are incurred at each turn. Quite frequently, the so-called "basic" rate finally became a nominal rate that applied to few, if any, actual transactions, which amounted to a retreat not only from rate stability but also from pursuit of the objective of dampening the impact of devaluation-caused price increases of "essential" imports.†

### *Conflicts of Policy Objectives in Multiple-Rate Systems*

Persistent inflation has thus been the principal factor in discrediting the stability aspect of fixed multiple-rate systems. A growing recognition of the inherent conflicts of policy objectives in the classification of exchange transactions according to differential exchange rates, on the other hand, appears to have been the major factor in the slow trend away from extreme rate multiplicity. It should be noted, even prior to discussing these conflicts of policy objectives, that our explanation of this trend is in some contrast with other possible explanations. Thus, it might be suggested that Latin American countries may now be more

\* The usual subsequent course of events has been the accumulation of a "backlog" of commercial debts abroad, which could be settled only with the assistance of official foreign lenders in a consolidation operation. In the most striking such case on record, Brazil accumulated unpaid bills variously estimated at from 500 million to 1 billion dollars prior to the virtual abandonment of its highly overvalued fixed rates in 1953, the settlement of which required large medium-term loans by the Export-Import Bank and British and German official agencies. Similar occurrences have been recorded during the postwar period on one or more occasions in Argentina, Chile, Colombia, and several of the smaller South American countries.

Although sometimes viewed by cynics as a means of augmenting the flow of private and official capital to underdeveloped countries, this method is in fact extremely damaging to the long-term credit standing of all borrowers, official and private, in the countries concerned. Moreover, it tends to result in a considerable (although probably non-measurable) deterioration of the terms of trade for the affected countries because of the addition of "special-risk" allowances to the normal price quotations of foreign suppliers.

† This process can be traced in the records of exchange regulations of the countries that have used fixed multiple rates during a substantial part of the postwar period. It is instructive to observe how in a majority of cases, through a series of changes in controls, the "basic" rate finally became purely nominal, applying to hardly any category of exchange transactions.

aware of the adverse effects of restrictions on their foreign trade as a whole that are implicit in multiple-rate systems; or that the inevitable arbitrariness of administrative decisions regarding "appropriate" exchange-rate and commodity classifications has led to an aversion to making such decisions. Although these objections to multiple rates have also frequently been recognized by Latin American policy makers, belief in the efficacy and desirability, *in principle*, of government interference with the allocation of economic resources appears to have waned little, if at all, during the past decade. One must therefore look to the practical difficulties in the application of the principle in the case of multiple rates for an explanation of the trend toward less complexity in exchange-rate systems.

The relevant policy conflicts may be summarized according to the four primary areas of impact of multiple rates—balance of payments, domestic price level, structure of production, and government budget. Policy conflicts result because any multiple-rate system (and any change in it) has eventual repercussions in *all* of these areas, even in cases in which the immediate objective of the authorities is to influence only one or a few of them. Thus, if an improvement in the country's balance of payments were to be the dominant criterion in the rate classification, the basic (least depreciated) rate would be made applicable to only a few imports (in terms of number of goods and volume of transactions), thus making the average selling rate of exchange relatively high. By the same criterion, only those exports with a very low elasticity of supply (and those for which the country is a non-atomistic supplier) would be made subject to penalty buying rates, since a broader application of such rates would presumably reduce exchange earnings significantly by keeping the average buying rate of exchange relatively low.

These balance-of-payments considerations, however, tend to conflict with the domestic-price-level criterion. This criterion, as will be evident from the earlier listing of typical objectives of multiple-rate systems, suggests that the fewest possible imports should be placed in penalty selling-rate categories in order to avoid major increases in home prices of imported goods. Moreover, a similar conflict exists on the export side if export goods are also important items of domestic consumption. While granting preferential rates to such exports may be desirable from the point of view of the balance of payments, such high rates are also likely to involve higher domestic prices for the goods in question.

Additional conflicts arise when the impact of multiple rates on the structure of home production is taken into account. For example, expansion of the domestic production of imported "essentials" (such as

foodstuffs and industrial raw materials) has often been an important policy objective in Latin America. It follows that these goods should be placed in the penalty selling-rate categories in order to grant them a greater degree of specific protection. Such a policy, however, is in obvious conflict with the price-level criterion, although in accord with the balance-of-payments criterion. Similarly, as regards exports, the most widely applied criterion in multiple-rate classifications has been that the export structure should become more diversified in order to lessen dependence on one or a few "traditional" exports. The consequent application of penalty rates to such "traditional" exports and granting of preferential rates to other exports, however, frequently proved to be in direct conflict with the balance-of-payments criterion. The traditional rather than the new exports usually represented the area of the country's greatest comparative advantage and therefore also the best hope—at least in the short run—for maintaining or expanding foreign-exchange earnings.

The budget-revenue criterion, finally, always indicated the desirability of the widest possible spread between average buying and selling rates of exchange. Thus, it was in evident conflict with the price-level criterion on the exchange-selling side, since higher selling rates of exchange (on the part of an atomistic buyer in world markets) usually imply higher home prices for the corresponding imports. On the export side also, the revenue-criterion has proved to be in frequent conflict with the balance-of-payments and structure-of-production criteria for commodity classifications under multiple-rate systems. For example, granting of higher buying rates to selected exporters to stimulate exchange earnings necessarily changes adversely the balance of budget income and outgo from the operations of the rate system as a whole.

The actual postwar experience of many Latin American countries has amply illustrated the existence of such conflicts. Moreover, it has in at least some cases demonstrated dramatically the adverse effects of following any one of these major criteria at the expense of the others, and of the extreme difficulty, in practice, of striking a balance among them. Thus, in several of the countries penalty rates of exchange for "traditional" exports have proven destructive of the incentive to produce and export these commodities, with a consequent undermining of the country's exchange-earning capacity.\* In other cases, the perverse ef-

\* The declining trend in total volume of Argentine and Uruguayan exports during most of the postwar period, for example, has been closely related with (a) prolonged enforcement of severe penalty rates for traditional exports—such as meat and cereals in Argentina, and meat and raw wool in Uruguay; and (b) insufficiency of the stimulus given by preferential rates to other exports. The persistent overvaluation of the

fects upon the structure of home production of selling rates of exchange dominated by the price-level criterion became obvious when domestic production of "essentials" failed to expand or even declined while production of "inessentials" and "luxuries" was stimulated.\* In other cases, the exchange system became a source of net government expenditures rather than of net revenues when balance-of-payments considerations dictated the transfer of additional exports to preferential buying-rate categories while price-level considerations held up the transfer of additional imports to penalty selling-rate categories.† In sum, the efficacy of multiple rates for the achievement of frequently contradictory economic and social objectives was overestimated in earlier years. Thus, partial or even complete exchange-rate unifications were frequently the ultimate outcome, although these steps were often delayed while rate and commodity reclassifications and piecemeal introduction of fluctuating rates were being used as interim measures.

## 2. INTRODUCTION OF FLUCTUATING RATES INTO FIXED MULTIPLE-RATE SYSTEMS

The effects of frequent reclassifications of commodity categories under fixed multiple-rate schemes and of the creation of additional, more depreciated rate categories have already been noted. To repeat, these changes amount to a retreat from the principle of fixed rates and in-

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respective rate systems as a whole of these two countries has, of course, added to the damage to export incentives.

\* E. M. Bernstein, *op.cit.*, pp. 230-231, gives several concrete instances, for Ecuador and Peru, in which production of "essentials" that were already supplied in part by domestic producers was impeded by preferential selling rates granted corresponding imports. Another and far broader example of such effects is to be found in Chile, where stagnation of agricultural production since the 1930's and the increase and diversification of production of manufactured goods in the same period is due, at least in some measure, to preferential and penalty selling rates prevailing during most of the period for the former and latter type of commodities, respectively. The Chilean case also illustrates the widespread use, throughout Latin America, of differential selling rates of exchange as an adjunct to a general economic policy aimed at industrialization. That is, preferential selling rates are usually applied to "essential" unprocessed foodstuffs and raw materials for industry, while processed foods and finished manufactures are placed in penalty-rate categories on the ground that they are "inessentials."

A deliberate policy of industrialization must of course be judged on its own merits. It is clear, however, that balance-of-payments and price-level criteria frequently used to defend an exchange-rate classification of imports as here described can also serve as a smokescreen to provide protection for interested industries.

† Argentina, Chile, and Uruguay are the leading examples of countries in which net losses rather than net revenues from exchange operations have occurred during substantial parts of the postwar period. Even more frequent have been cases such as that of Brazil in the years 1954-1957, where initially large net revenues following major exchange reforms have shown a tendency to decline rapidly later on without, however, causing more than occasional net losses.



volve the loss of many of the advantages of this system. It follows that frequent changes in the effective rates of a fixed multiple-rate system are also an acknowledgment of the possible desirability—and more often of the virtual necessity—of using exchange rates as a part of the adjustment mechanism to cope with balance-of-payments problems created by persistent inflation. We may now trace the additional reasons, actual processes, and problems of a formal introduction of fluctuating rates into fixed-rate schemes.

In this connection, it is advisable to distinguish, as has been done in the table, between so-called free “financial” rates (category 3), and the extension of the application of fluctuating rates to selected commodity transactions (category 4). This distinction corresponds to the observed evolution of rate systems in a number of cases. Moreover, the motives and objectives of using fluctuating rates have differed at times between the two cases.

The most important function of a subsidiary free exchange market for financial transactions within a fixed-rate system has generally been that of serving as an “escape valve” for balance-of-payments pressures—i.e., pressures that arise from actual or potential demand for exchange in excess of potential supplies at the prevailing fixed-rate structure. This demand was then channeled into a free exchange market, in which, at least initially, the supply was usually expected to come from new investments of foreign capital, from tourist expenditures, and also from repatriation of previously exported domestic capital. The very establishment of a free rate, indeed, was quite often motivated by the hope that to permit *all* exchange transactions at *some* rate would reverse, or at least stop, an earlier clandestine capital flight through an illegal or “gray” exchange market. More generally, however, the authorities of many of the countries have felt that a free financial market would provide a measure of protection against the capital flights that have often followed initial declines in official international reserves for whatever cause—political disturbances, harvest failures, export-price slumps, or inflationary pressures. If permitted to exert their full impact on the official reserve position, such capital flights might have necessitated a devaluation that would not have been warranted in view of the trends in the other components of the balance of payments. Alternatively, they might have necessitated imposition of stronger exchange controls on capital movements—a type of control that is notoriously difficult to enforce in most Latin American countries. Thus, establishment of a free financial market often represented a broadened application of the reasoning behind the partial devaluations implicit in adding fixed, but more depreciated, minor rates to a basic rate.

In a vast majority of cases where a free financial rate was introduced into a fixed-rate system, a problem has arisen with regard to the "proper" relationship between the fixed rates and the free rate. It was usually taken for granted that the free rate should be significantly lower than the basic rate, and in most cases also lower than other fixed rates applicable to a significant volume of actual exchange transactions. The reasons are, of course, that the free rate should serve as a curb on capital flight while also encouraging potential new supplies of exchange. In practice, however, the much more important question has usually been how far the free rate could be permitted to depreciate below the fixed rates without consequences so undesirable as to offset the advantages of the free rate.

In order to appreciate the importance of this question, it is necessary to describe briefly the disadvantages of an "excessive" spread between the free and the fixed rates. In the first place, the problem of enforcing exchange controls usually became very serious when the exchange-rate incentive for underinvoicing exports and overinvoicing imports became significant.\* In this manner, relief from pressure on official reserves obtained by creating a free market was often reduced greatly and, it will be noted, the scope of the free market in fact widened beyond "financial" transactions. In the second place, any sudden and major (as well as any slow but chronic) depreciation of the free rate tended to set into motion a chain of events that threatened, or actually brought about, a devaluation of the entire fixed-rate structure. For example, once evasion of exchange controls became widespread—because of an excessive spread between the free and the fixed rates—pressure on official international reserves recurred. This pressure led in turn to speculative overimporting and to withholding of exports in anticipation of a devaluation of fixed rates that then became inevitable.

One defensive measure that has been used frequently against threats posed to the fixed-rate structure by a depreciating free financial rate has been a *de facto* management of the latter rate by exchange authorities so as to avoid an "excessive" spread. It is evident, however, that this

\* That is, where buying rates for export proceeds valued the local currency significantly higher than did the free rate, exporters found it worthwhile to run the risk of underdeclaring the actual foreign-currency value of their exports for the purpose of satisfying the official exchange-surrender requirement while repatriating the remainder through the free market. Importers followed the opposite course, with the same result, by overstating their exchange requirements and selling the excess thus obtained in the free market. The precise "margin of tolerance" between fixed and free rates before such operations become sizable varies greatly from country to country. As a rule of thumb; however, it would appear that a 10 percent spread between the basic rate and the free rate constitutes a limit beyond which controls cannot be strictly enforced in most countries.

policy tended to reduce the free rate's potential as a deterrent to capital flight. More important yet, to the extent that the officially imposed slowing down of, or outright limitation on, the depreciation of the rate involved large net sales in the free market on the part of the authorities, no relief from the steady drain on official reserves arising from overvalued fixed rates was actually obtained. For this reason, the "financial" free rates frequently failed to remove the dilemma of exchange authorities caught between the desire for stable exchange rates for major balance-of-payments items and the inability to curb the factors making for capital flight.

The persistent overvaluation of fixed rates under protracted inflation and the attendant strains on international reserves and exchange-control machinery, together with *de facto* abandonment of rate stability through frequent multiple-rate reclassifications and free "financial" rates, have thus induced country after country in Latin America to adopt fluctuating rates for at least a part of its commodity transactions. The precipitating reasons for adopting such measures, as well as their exact forms, have varied greatly with the individual case. What the measures have shared with one another, however, has been a tendency to bring the mechanism of flexible exchange rates to bear upon the major components of foreign-exchange transactions, i.e., merchandise exports, or imports, or both.

The immediate effect of these new policies on the balance of payments has usually been salutary. Thus, the transfer of certain imports to what was originally the free financial market—or to a newly created special market in which exchange (or rights to exchange) from official exchange resources is auctioned off—enabled the authorities to relieve the pressure on official reserves through the attendant rise of the average selling rate for foreign exchange. For the same reason, these measures frequently permitted a relaxation of quantitative import restrictions and thus also a curbing of importers' windfall profits. Furthermore, the mechanism of fluctuating rates for imports, once established, increased the room for maneuver by the exchange authorities since they could now transfer additional commodities to fluctuating-rate categories.

Similarly, the advantages on the export side have often been substantial. The granting of permission to convert in the free market part or all of the exchange earnings from one or more selected commodities frequently increased the short-run supply of foreign exchange to the economy (although of course not necessarily the exchange available to the authorities) by breaking the deadlock between the authorities and

the exporters concerned. Even more important, the partial free-market conversion of export receipts provided a basis for more rapid and more certain adjustments of exporters' receipts to rising domestic costs.\* The damaging price-cost squeezes associated with the combination of persistent inflation and fixed exchange rates were thus eased.

Experience has also shown, however, that the combination of fixed and fluctuating multiple rates for commodity and financial transactions that still prevails in much of Latin America accentuates in some respects the policy conflicts of the earlier fixed-rate schemes and also creates new and serious problems. Perhaps the most prominent among the latter has been the initial proliferation of exchange rates following the institution of partial free markets for trade transactions. A system that combines fluctuating and fixed rates with "rate mixing," exchange auctioning, and similar devices has obviously come a long way from the relative simplicity of a fixed multiple-rate system with one basic and a few minor rates. In actual fact, there have been several rate systems in force in recent years in which literally hundreds of exchange rates have been simultaneously effective.† The intricate interrelationships of these rates have quite naturally created new opportunities for windfall profits through commodity and exchange arbitrage, while also making it difficult if not impossible to make effective any given rate-policy decision of the authorities without bringing about unintended and undesired side effects. To name only one of the typical difficulties: where exporters were granted limited free-market conversion privileges because of otherwise insufficient export incentives, it became clearly desirable to

\* This effect results from the fact that the free rate tends to rise readily with domestic price and cost levels, while the periodic devaluations of fixed buying rates of exchange for exports tend to lag behind the pace of inflation. (There is, of course, no simple mathematical relation between internal depreciation of a country's currency and depreciation of the free-market exchange rate. It cannot be predicted, for example, that with a 10 percent increase in the domestic price level—whatever the correct measurement of this elusive concept may be—the free exchange rate will rise immediately by this or any other predetermined percentage. Direct and indirect official interference in the "free" exchange markets—including the partial transfer of various commodity transactions to these markets—and psychological factors are but two of the many influences that may and have precluded such possible simple relationships. Nevertheless, except in cases of outright official stabilization of "free" rates, such rates have generally adjusted more rapidly in response to domestic inflationary pressures than fully administered fixed rates.)

† The Brazilian exchange-rate system, as it stood shortly after the introduction of differential export "bonuses" and of exchange auctioning with differential import categories in October 1953, is probably the outstanding example of extreme rate multiplicity in postwar Latin America, although similar conditions have at times prevailed in Argentina, Bolivia, Chile, Paraguay, and Uruguay. For an analysis of the rationale and the effects of the Brazilian system, see A. Kafka, "The Brazilian Exchange Auctioning System," *The Review of Economics and Statistics*, August 1956, pp. 308-322.

permit the free rate to depreciate significantly below the fixed export rates.\* Yet, to do so resulted frequently in a direct conflict with the objective of avoiding an excessive spread between the system's fixed rates and the free rate.

The addition of fluctuating rates for selected commodity transactions, furthermore, has invariably led to increased pressure upon the remaining fixed rates. It is evident that the usual circumstances of introducing fluctuating rates implied a devaluation of the rate system as a whole. Therefore, the remaining fixed rates became relatively even more overvalued, with a consequent further encouragement of imports and discouragement of exports remaining in fixed-rate categories. Thus, additional devaluations of the fixed rates with all the adverse consequences mentioned earlier became necessary eventually.†

It is hardly surprising, therefore, that in numerous cases a consolidation of the effective rates into one or a few rate categories was finally considered. Nor is it surprising, in view of the postwar record of fixed exchange rates in Latin America, that one of the major points at issue in such consolidations was whether the fluctuating rates could be fully unified and made applicable to all exchange transactions. The main examples of a complete or nearly complete achievement of this goal are the four countries that by the end of 1957 had passed into rate categories 5 and 6 of the table—Bolivia, Chile, Paraguay, and Peru—all of which had the complex systems of categories 3 or 4 just prior to the latest exchange reforms. There are other examples, however, in which fixed and fluctuating effective rates of category 4 systems have been reduced substantially in number, although the transition to categories 5 or 6 was not completed.‡ The next section will consider those cases in

\* A hypothetical example will illustrate the point. Assume a fixed buying rate of 10 pesos per dollar unduly discourages exports of a given good. It is then decided to require the exporters to surrender only 50 percent of their exchange receipts to the authorities at the fixed rate, while the other 50 percent can be converted in the free market. If the free rate is 20 per dollar, the effective rate resulting from the "rate mixing" will be 15 per dollar; but if the free rate is 30 per dollar, the effective rate will be 20 per dollar. Thus, with given proportions in the "rate mix," the higher the free rate, the higher the effective rate.

† It is assumed in this comment that at least some imports and exports were initially excluded from the transfer of commodity categories to the free market, so that the corresponding fixed rates remained fully applicable to these goods. This is a realistic assumption for most instances in which fluctuating rates have been gradually introduced into fixed-rate schemes.

‡ Thus, two major rate consolidations have taken place in Brazil since the October 1953 exchange reform. In one of these, in August 1955, the auctioning of a number of currencies of Brazil's European trade partners was unified in a "unit-of-account" dollar; in the other, in August 1957, the number of import classes under the auction system was reduced from five to two.

which fully fluctuating and substantially unified rate systems were actually put into effect. At this point some of the major obstacles to this final step will be noted.

Basically, these obstacles have been the same as those that in earlier periods convinced many Latin American exchange authorities of the desirability of fixed and multiple exchange rates, or of very limited application of fluctuating rates. Thus, in several of the largest countries—Argentina, Brazil, and Colombia—it continues to be deemed unacceptable to expose “basic” import items such as food staples and fuels to the immediate price increase and future price fluctuations that their integration into a unified fluctuating-rate system would entail. Maintaining preferential selling rates for these commodities, however, makes virtually inevitable the maintenance of penalty buying rates for broad groups of exports as well, since preferential selling rates without penalty buying rates would require that the local-currency funds needed to finance the import subsidies be found elsewhere.\* The avoidance of “excessive” or “unnecessarily high” incomes for exporters of “traditional” goods, as against those contributing to export diversification, continues to rank high among the reasons for exchange-rate discrimination among exporters, irrespective of whether these rates were fixed or partly fluctuating.† The arguments for an exchange market for financial transactions wholly or partly separated from the market for the bulk of commodity transactions also continue to be given considerable weight in a number of countries.‡ Last, but not necessarily least, it has frequently been found necessary to offset possible disruptive effects upon domestic producers and consumers of too rapid a transition to a unified rate. For example, domestic producers whose businesses have grown under the protection of penalty selling rates of exchange for competing imports have at times succeeded in making upward adjustments in

\* In practice, the central bank has frequently been an alternative source of these funds, with obvious inflationary implications.

† In addition, the continued employment of penalty rates for coffee and cocoa exports in Brazil and for coffee exports in Colombia is very likely also influenced by terms-of-trade considerations. Because of the prominent position these countries occupy as suppliers of the respective commodities in the world markets, it is believed that penalty rates help keep foreign-currency prices of these exports higher than they would otherwise be.

‡ Such free rates have at times been maintained for prolonged periods in the absence of serious strains on the balance of payments, e.g., in Costa Rica, Ecuador, and Nicaragua. During such periods, moreover, the central banks of these countries have frequently stabilized the “free” rate at a level only slightly below the basic rate of the multiple-rate system. Precaution has played a large role in these cases. Furthermore, the spread between free and fixed rates, though small, has afforded a convenient means of subsidizing marginal exports through “rate mixing” and similar devices.

tariffs a precondition of a major simplification (and eventual unification) of their countries' exchange rates. For these reasons, movement toward fluctuating and simplified rate systems has at times been a slow crawl or a grudging yielding of ground rather than a determined rush.

### 3. ADOPTION OF FLUCTUATING RATES FOR ALL EXCHANGE TRANSACTIONS

The experience of Latin American countries with fluctuating and substantially unified exchange rates is still quite limited because such systems have only recently come into being after extensive postwar experimentation with fixed and partially fluctuating-rate schemes. As noted previously, there were only four countries operating solely with fluctuating rates at the end of 1957.\* Furthermore, only one of these (Peru) had at that time been working with such a system for a substantial period (eight years), while the experience of the other three countries had been about two years or less. Nevertheless, this group of countries is fairly representative of Latin America as a whole in some relevant respects—such as proneness to persistent inflationary pressures, dependence on a few commodities for the bulk of their exchange earnings, and the pursuit of government policies aimed at industrialization and economic development in general.† Moreover, these countries as a group have already passed through a number of “representative periods” since the changeover to fluctuating rates—i.e., periods of alternating booms and recessions in world markets and of intense and more moderate inflationary pressures. It is therefore possible to make a preliminary evaluation of the experience with these new systems.

It is especially important to reemphasize that fluctuating exchange rates are considered here only as they function in relatively small countries that are atomistic buyers, and generally also atomistic suppliers, in world markets and whose currencies do not figure importantly in world trade and payments and in international reserves of other countries. Furthermore, it is important to recall once more that the alternative to fluctuating rates in these countries was not a single fixed rate subject to adjustment only on rare occasions of “fundamental disequilibrium.” Rather, as the historical record shows, the real alternatives were

\*The special 1957 year-end situation in Colombia, which might have been included in this group, is discussed in the note to the table.

†It should be pointed out, however, that inflation had been considerably more severe in Bolivia, Chile and Paraguay than in other Latin American countries before the advent of the stabilization programs and exchange reforms of 1955-1957 in these three countries.

the combinations of fixed multiple and fluctuating rates of limited applicability discussed earlier.

With these important reservations and certain others to be mentioned later, it is fair to say that Latin American experience with fluctuating exchange-rate systems has on the whole been favorable. This favorable influence has been especially notable with regard to the balance of payments. In this area, adoption of fluctuating rates for all exchange transactions has usually added to the advantages derived from the earlier adoption of flexible rates as a partial aid in balance-of-payments adjustments. Thus, the rate depreciation that would be expected and that has usually followed substantial inflation of domestic origin, or declines in world market prices for major export products, has helped the countries affected to maintain their volume of exports and their exchange earnings. The nondiscriminatory nature of a unified fluctuating rate for exports has been of special importance in this regard since the existence of such a rate means, of course, that the authorities no longer penalize suppliers of "traditional" (or any other) exports through rate discrimination. This also helps explain why adoption of fluctuating-rate systems has in several cases under discussion been associated with a substantial inflow of private foreign capital into export industries.\*

\* This and most of the other important aspects of the early years of the Peruvian experience with fluctuating rates are discussed in S. C. Tsiang, "An Experiment with a Flexible Exchange Rate System: The Case of Peru, 1950-54," *International Monetary Fund Staff Papers*, February 1957, pp. 449-476.

It will be recalled that in the four countries in question, as well as in most other Latin American countries, foreign investment is still concentrated heavily, although by no means exclusively, in export industries. It is also noteworthy that adoption of fluctuating-rate systems was associated in all four cases with an improvement in "investment climate." This change in official attitudes found concrete expression not only in the abolition of discrimination in export exchange rates but also in the enactment of new legislation aiding foreign investors in such matters as taxation, guarantees against expropriation etc., at approximately the same time as the reform of the exchange system. It is implicit in the foregoing that, generally speaking, foreign investors have been and still are among the major victims of the disincentive and discriminatory effects of overvalued fixed multiple-exchange-rate systems.

It may also be noted that there is some controversy as to the general usefulness and desirability for underdeveloped countries of foreign capital investment in "export-oriented" industries. This writer believes that such investments have on the whole been beneficial to Latin American countries by raising the exchange-earning potential, widening the tax base, and spreading modern production techniques. Therefore, if unified fluctuating rates have attracted more foreign investment to Latin American export industries than the rate schemes used earlier—and limited experience suggests that they have done so—this is deemed to be one of their advantages. (For a discussion of possible qualifications to be made as regards the benefits of such investments, see H. W. Singer, "The Distribution of Gains between Investing and Borrowing Countries," *The American Economic Review, Papers and Proceedings*, May 1950, pp. 473-485.)



With regard to imports, freely fluctuating exchange rates have usually permitted further relaxation or even outright abolition of quantitative import restrictions. They have therefore also contributed to easing the economic and institutional problems inherent in the allocation of exchange through administrative machinery. Furthermore, the immediate impact on the domestic price level of depreciation of the average selling rate for exchange that usually accompanied the broadened application of fluctuating rates to all exchange transactions was often less than might have been expected on the basis of a comparison of relevant exchange rates before and after the measure, since the internal prices of imported goods had invariably reflected not only normal costs of importing but also "abnormal" markups and speculation.\* It should be noted, however, that this comparative insulation of the internal prices of imported goods from the effects of a depreciation of the exchange rate has generally been confined to an initial period lasting no more than perhaps a few months. Subsequent depreciations of such rates have tended to be fully reflected in import prices.† This has constituted one of the major problems in the management of such rates, as will be noted later.

In most discussions of fluctuating exchange rates, the possibility of disequilibrating capital movements is rated high among the potential or actual disadvantages of such rates. In particular, it is often feared that a relatively moderate initial depreciation of such rates, for whatever reason, will induce capital flights of such magnitude as to lead to cumulative depreciation, regardless of the trends in the other components of the balance of payments. It should be clear that this danger is much greater if a country has not yet been "conditioned," as many Latin American countries are by now, to frequent *de facto* declines in

\* A striking example of an actual decline in the prices of certain imported goods following a depreciation of the exchange rate applicable to those goods and the simultaneous ending of quantitative import restrictions is given, for the case of Peru, in E. R. Schlesinger, *op.cit.*, pp. 20-22. An additional (or alternative) benefit has sometimes been the end of shortages (or the virtual unavailability) of a broad range of imports. Such shortages were frequent and widespread in Bolivia and Chile prior to the relaxation of quantitative restrictions which followed adoption of fluctuating-rate systems.

† A qualification of this statement should be made for those cases in which a relatively high elasticity of supply of domestic substitutes for imported goods, at prices corresponding to the pre-depreciation and post-depreciation exchange rates, has been found to prevail. In terms of the entire range of imported goods, however, such cases have not been frequent, especially since such possibilities for increasing the domestic supply usually take a good deal of time before they become effective in practice. They should of course not be deprecated on this account; on the contrary, the ending of preferential selling rates for so-called "essentials" may well turn out to be a more effective incentive for increased home production of such goods, in the longer run, than alternative stimuli.

the external value of its currency regardless of which exchange-rate system exists *de jure*. Nevertheless, this danger has always been recognized by Latin American exchange authorities and has usually contributed greatly to the adoption, simultaneous with that of fluctuating exchange rates for all exchange transactions, of one or a combination of the following: full-scale stabilization programs involving major measures designed to curb domestic inflationary pressures; official management of fluctuating rates so as to avoid disruptive and "excessive" rate fluctuations, but without resisting "basic" trends in the rates; the strengthening of official international reserves through standby credits from abroad; and continued attempts to separate trade from capital transactions through administrative regulations.

While these measures have usually sufficed to prevent an overly rapid depreciation of the exchange rates for reasons of capital flight alone, other and broader problems in the administration of the fluctuating-rate systems have continued to occur. The most important of these has been whether exchange rates could in fact be expected to bear the entire burden of adjusting the balance of payments even in cases (and *particularly* in cases) where the adjustment was required because of "basic" rather than temporary or "speculative" tendencies toward rate depreciation. In all the countries using only fluctuating rates in recent years inflationary pressures of domestic origin have continued, in spite of frequent notable successes in slowing down the rate of inflation through stabilization programs. These pressures should probably be considered a "basic" trend making for rate depreciation.\*

At times, this trend has been partly or fully offset by favorable world market prices for the major exports and by the rise in volume brought about by measures for stimulating exports. Thus, the pressure from domestic sources toward exchange-rate depreciation was offset in part by favorable external factors. At other times, however, declining world market prices have reinforced domestic factors making for rate depreciation. On such occasions, the managers of the exchange-rate systems of the countries in question have had to face the distinct possibility that the impact of a depreciation corresponding fully to the "basic" trends would set off new and even more severe inflationary pressures, especially because of the strong likelihood of irresistible demands for wage increases following rapid and substantial increases in the prices of imported "essentials." Thus, the exchange rate itself might have become a causative element in a renewal of inflationary pressures as severe as

\* For obvious reasons, the distinguishing of "basic" and "temporary" trends constitutes in itself one of the difficulties in administering fluctuating exchange rates.

those that had led to the stabilization programs and exchange-rate reforms in the first place.

Indeed, under these conditions the magnitude of the required exchange-rate adjustment becomes a dubious quantity. None of the price- and income-elasticity measurements usually deemed relevant in estimating the effect of exchange-rate depreciation upon the balance of payments would alone provide an answer, since it is the essence of the problem that the rate depreciation itself might cause an increase rather than a decrease in the demand for foreign exchange via the route of higher money incomes plus anticipation of further rate depreciations. In practice, the useful (and feasible) degree of rate depreciation in such unstable environments must be based largely upon judgments regarding (a) the relative degree of encroachment upon the real income of the major groups of income recipients that various alternative exchange rates would entail; (b) the intensity of the economic and political pressures that these groups can bring to bear upon the authorities; and (c) the degree of resistance that the authorities are able to offer such pressures.\*

In view of this difficulty, the exchange authorities have usually continued to employ various devices useful in restraining the demand for exchange through means other than fluctuating exchange rates. In some instances, extensive use of such devices has been made.† Furthermore, apprehension regarding the possible adverse effects of excessively rapid depreciation has led to a tendency in some of the countries to delay or slow up a developing depreciation of fluctuating rates through substantial net sales of foreign exchange from official reserves and

\* An excellent description of these dilemmas of exchange-rate policy is given in O. E. Moore, "The Stabilization of the Bolivian Peso," *Public Finance*, No. 1/1958, pp. 43-68 (especially pp. 58-59).

It may also be worth noting that foreign advisers who have been involved in the process of making exchange-rate policy in these Latin American countries (and who have thus come face to face with the possible consequences of major errors in rate policy) have generally acquired a somewhat more sympathetic attitude towards the perpetual attempts of Latin American authorities to isolate "essential" imports from general exchange-rate adjustments. This is true in spite of the repeated failure of such attempts in some cases, and in spite of their perverse effects on the structure of home production in other cases.

† Most notable among these techniques is the requirement of advance deposits on imports, which has been used throughout the period of fluctuating rates in Chile and Paraguay, as well as in numerous Latin American countries still operating with other exchange-rate systems. Because of the additional financing charge involved in complying with such requirements, advance deposits on imports can and have been used to curb import demand in general as well as to discriminate, through selectively higher and lower requirements, between various classes of imports. For a full discussion, see J. Marshall, "Advance Deposits on Imports," *International Monetary Fund Staff Papers*, April 1958, pp. 239-257.

standby credits.\* Depending on the circumstances, however, such rate policies have sometimes also reflected a reasonable hope for an early reversal of trends in exchange markets.

In sum, recent experience with fluctuating rates in Latin America suggests that such rate systems have usually been of great aid in effecting more orderly balance-of-payments adjustments than had been the case under the earlier exchange-rate systems. Furthermore, fluctuating rates have often permitted major relaxations of direct restrictions on the trade of the countries in question and have usually involved far less discrimination between the participants in the countries' international transactions. Thus, their adoption has also been associated with a clearer recognition of the inherent and virtually insoluble conflicts of policy objectives of multiple-rate schemes.

However, experience also suggests that fluctuating rates have worked most effectively in these directions where the burden placed upon them, in terms of domestic inflationary pressures and export-price declines, has been relatively moderate. The term "moderate," however, should be interpreted liberally. In assessing relative advantages and disadvantages, the authorities of many Latin American countries, as well as the participants in trade and payments and the general public of the countries concerned, have gradually come to compare fluctuating-rate systems with the still less desirable alternative rate systems that in fact prevailed during the earlier postwar period rather than with utopian systems of one or a very few fixed and rarely adjusted rates.

### III. CONCLUDING OBSERVATIONS

It is perhaps premature to suggest that the postwar experience of Latin American countries with various alternative exchange-rate systems may have a wider and more lasting impact on international financial policies than might be expected in view of the relatively small share

\* It should be emphasized that as a general rule—and not only in the above-described circumstances—there is a question as to what degree a fluctuating rate can (or should) ever be free from official intervention. Under the existing institutional arrangements in Chile, for example, from one-half to two-thirds of the total supply of exchange in the market for trade transactions has come from taxes paid in foreign currency to the government by the large foreign-owned copper companies, and from the conversion by these companies, at the central bank, of exchange needed to cover local production costs. In Bolivia, the proportion of the exchange supply derived from official receipts is even higher because of government ownership of large mining enterprises. Hence, the rates for trade transactions in these two countries have necessarily been "administered" rates.

In Peru, where the institutional circumstances are more favorable to genuinely free exchange markets, the major rate (i.e., that for merchandise as distinct from that for capital transactions) was actually held stable for a period of over three years (in 1954-1957) by central bank intervention. During that period, however, this central

of these countries in the total of international trade and payments. Nevertheless, there are indications that this may be the case.

It is noteworthy, for example, that the International Monetary Fund has found it compatible with its objectives and its Articles of Agreement to participate in the provision of standby credits for each one of the Latin American countries that has in recent years made the transition to substantially unified fluctuating-rate systems.\* In finding this assistance justifiable, the Fund has rightly placed the major emphasis upon the *substance* of the change involved—relatively greater freedom of international trade and payments, improvement in the allocation of resources implicit in reducing the scope of discriminatory exchange rates, and promotion of domestic stabilization programs associated with exchange-rate reforms—while disdaining to defend the shadow of stable but overvalued rates that had had to be bolstered by severe quantitative restrictions.

To be sure, the Fund's pronouncements at the time it granted standby credits usually implied strongly that fluctuating rates were approved only as a transitory phase of exchange-rate policy, to be followed by the adoption of new and fixed par values as soon as the exchange-rate management of the countries had been guided by free-market forces toward permanently sustainable rates. In the face of continued inflationary pressures and export-market instability in these countries, however, the Fund found other alternatives less desirable than fluctuating rates and is even known to have urged, on occasion, a more intensive use of the exchange-rate instrument in effecting required balance-of-payments adjustments than the countries involved were willing to undertake. This Fund policy has, of course, been partly motivated by a legitimate concern over the possibility of excessively large and rapid drawings on the standby credits, and by well justified apprehensions regarding the potential carrying-over of a tradition of overvalued rates into the management of the new fluctuating-rate systems. Nevertheless, such episodes strengthen the impression that in actual practice fluctuating exchange rates are not necessarily anathema to the Fund.

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bank policy involved neither heavy net sales nor large net purchases of exchange by the central bank and was discontinued in early 1958 after severe pressure toward rate depreciation had recurred.

\*In all four cases, the standby credits were granted as a part of "package deals," in which the countries concerned committed themselves to general stabilization programs as well as to continued consultation with the Fund on exchange policies. In the Bolivian, Chilean and Paraguayan cases, the standby credits were agreed upon at the time of the transition to fluctuating exchange rates; in Peru, such rates had been in effect for several years before the occasion for a use of the Fund's standby credit facilities arose. The United States Treasury and commercial banks in the United States were other participants in the standby credits in several cases.

It is also noteworthy that a number of Asian and Middle Eastern countries have in recent years begun to experiment with multiple fixed and partially-fluctuating exchange rates in a manner not unlike that of Latin American countries. This experimentation may well be the prelude to similar occurrences in a number of other underdeveloped countries, many of which have only recently gained full authority over their exchange-rate systems while also becoming more subject to the various types of pressure making for *de facto* instability of exchange rates.

The adoption of fluctuating-rate systems by large groups of underdeveloped countries would of course raise problems for each of the countries concerned and for world trade and payments in general that far transcend the problems of such rates when their use is confined to a few countries. These new problems may well be worth further exploration. It can still be conceded readily that fluctuating exchange rates are second best to fixed and nondiscriminatory exchange rates even in developing primary-producing countries—provided that internal development takes place without major inflationary pressures and that substantial stability prevails in the markets for the exports of these countries. But are these conditions likely to be fulfilled in the world of today and tomorrow?

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