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Multiple Exchange Rates and Economic Development

Eugene Richard Schlesinger

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2. MULTIPLE EXCHANGE RATES AND ECONOMIC DEVELOPMENT, BY EUGENE RICHARD SCHLESINGER

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By Eugene Richard Schlesinger

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This is the second number in the series called Princeton Studies in International Finance, published from time to time by the International Finance Section of the Department of Economics and Social Institutions in Princeton University. The first was *Monetary and Foreign Exchange Policy in Italy*, by Friedrich A. and Vera C. Lutz, published in January 1950. The present study was developed out of portions of a doctoral dissertation submitted by Dr. Schlesinger to Harvard University in 1950. Dr. Schlesinger is now an economist with the Federal Reserve Bank of New York. Nothing in this study should be considered an expression of the views of that institution.

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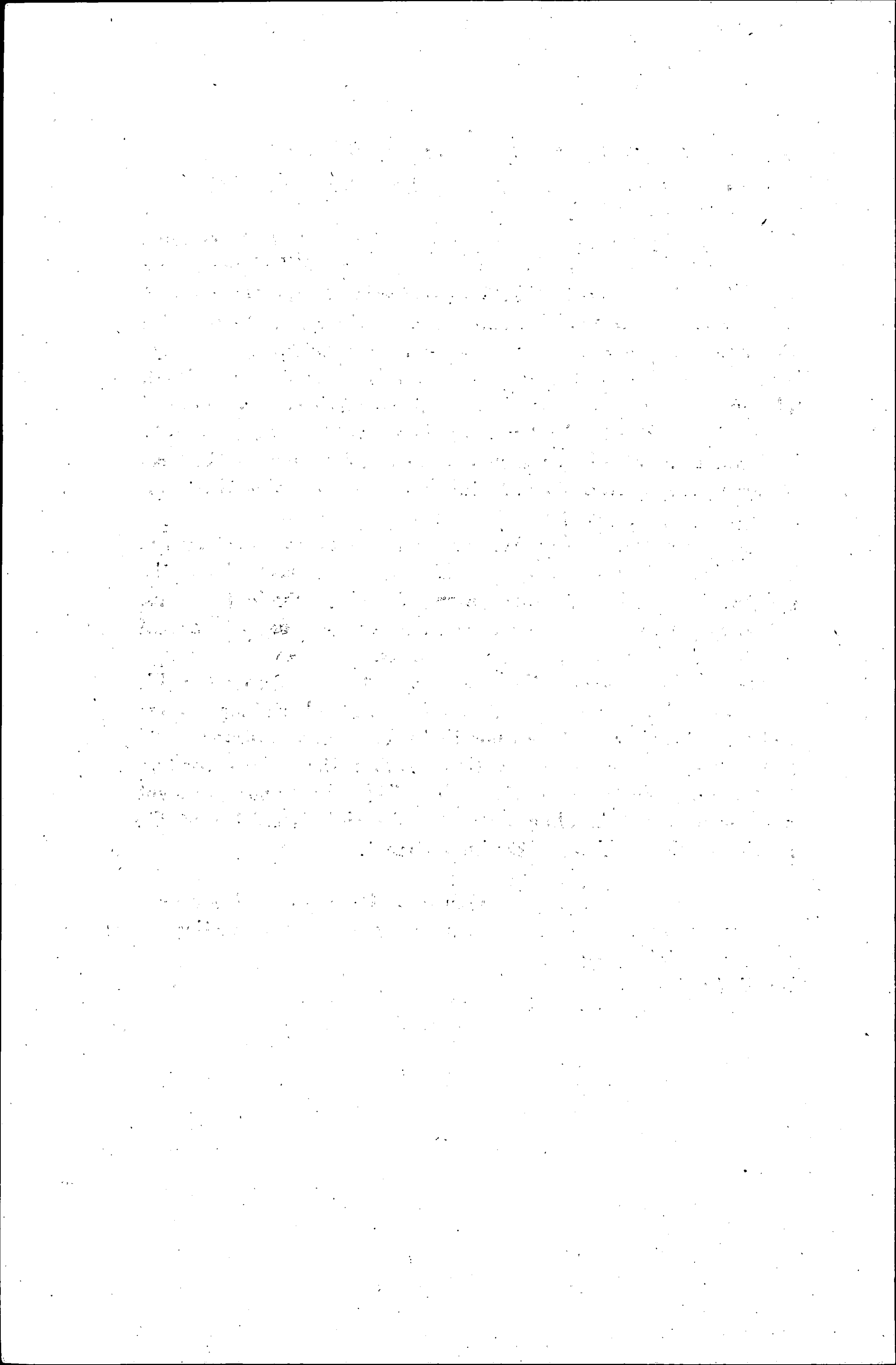
Princeton University
April 1952



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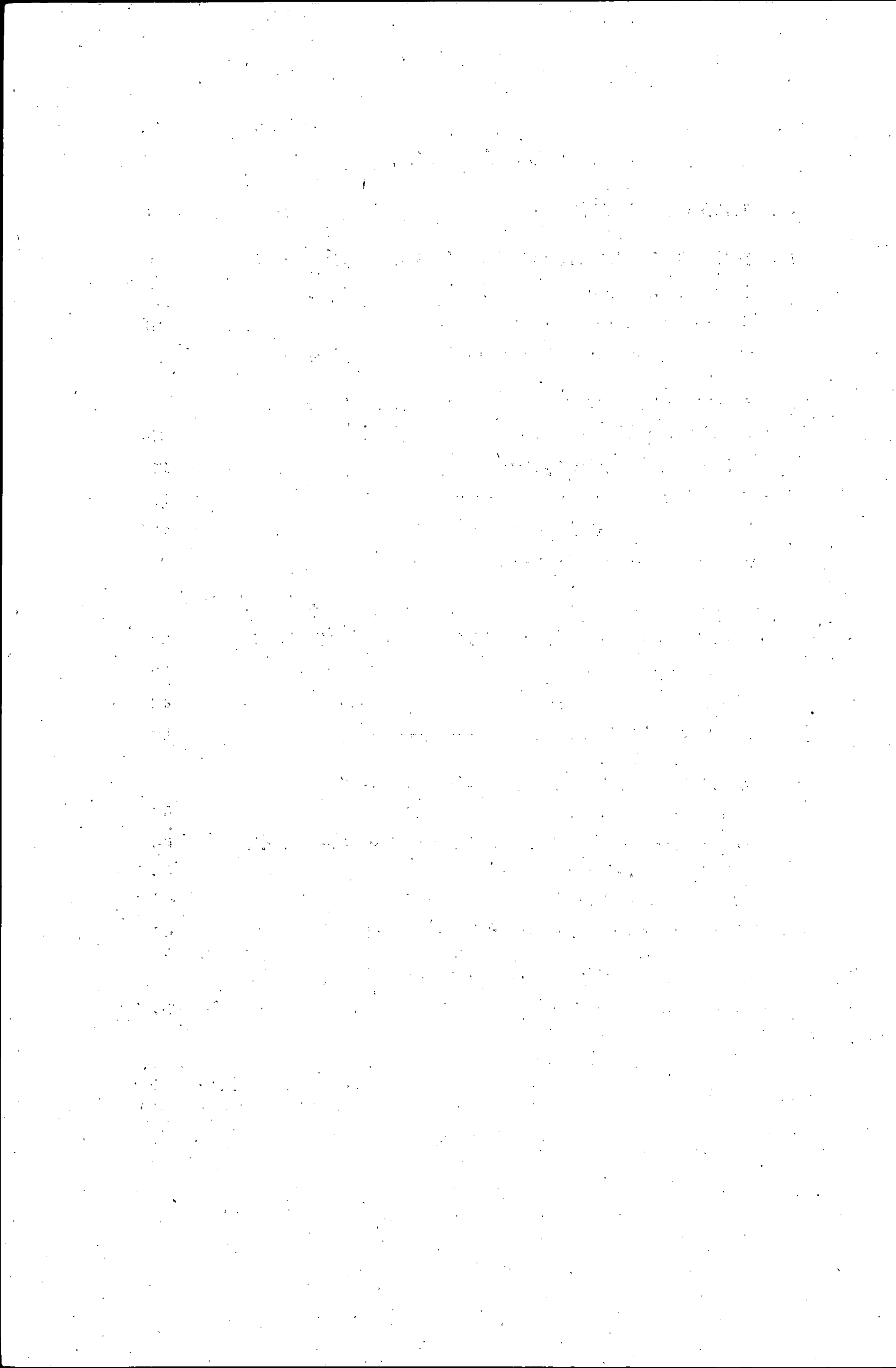

I. Introduction

One of the most striking and significant trends in the pattern of development of exchange restrictions since the end of the war has been the spread of multiple exchange rates, particularly among the economically less developed areas of the world. Although this special form of exchange control has, to be sure, also been put to use by such Western European industrial countries as France and Italy, its utilization by more than half of the twenty Latin American republics—and by such widely differing countries as Greece, Indonesia, Israel, Lebanon, Spain, and Thailand—suggests that modern multiple exchange rate systems are particularly suited to the economic structures and problems of low *per capita* income countries whose international trade consists essentially of exchanging exports of primary products for imports of capital equipment and other manufactured goods.[1] Considerable interest attaches to a discussion of this hypothesis in view of the deep-seated and growing opposition in the United States and other quarters to any country, underdeveloped or not, which wishes to retain exchange restrictions on current account or to continue multiple currency practices.[2]

Multiple exchange rates originally became important as depression-born devices, and like other forms of exchange control were very much criticized in the literature of the 1930's and early 1940's. In fact, because of a popular tendency to identify them with the German system, multiple rates came to be considered a particularly abusive form of exchange control, and Professor Ellis' characterization of the German setup as a development "from an emergency measure to a totalitarian system"[3] can thus be taken readily as being typical of the traditional libertarian view of multiple rates. In most other countries, particularly those

[1] For a complete list of countries which have used multiple rates in recent years consult the International Monetary Fund, *First Annual Report on Exchange Restrictions*, Washington, D.C., March 1, 1951 and *Second Annual Report on Exchange Restrictions*, Washington, D.C., April 6, 1951.

[2] With the end of the five-year transitional period (March 1952) that was specified in the Articles of Agreement of the International Monetary Fund, the Fund authorities must be consulted by any country which desires to retain these devices.

[3] H. Ellis, *Exchange Control in Central Europe*, Cambridge, Harvard University Press, 1941, p. 158.

of Latin America, the multiple exchange rate systems of the interwar period did not, of course, bear the taint of totalitarianism. They were considered for the most part as emergency or discriminatory devices introduced for psychological reasons or such special purposes as easing the burden of the external debt service;[4] particular emphasis was given to their utilization as a method of relaxing quantitative exchange restrictions;[5] and little attention was paid to the possibility of using them as an alternate or independent way of curbing exchange disbursements.

A number of countries retained or expanded their multiple exchange rate systems during the period following World War II, while other nations introduced these instruments for the first time. In general the reasons for using multiple rates appear to have been the same as in the 1930's: emergency conditions, this time of an inflationary rather than a deflationary nature, existed, and ample opportunities for discrimination were afforded. The most basic difference between prewar and postwar systems has probably been the growing use of multiple rates as independent restrictive devices; the International Monetary Fund now makes a sharp distinction between *cost* restrictions and *quantitative* restrictions, classifying multiple exchange rates as the former[6]—a point of departure which contrasts significantly with the *measures of relaxation* approach that was employed by the League of Nations.[7] One important result of this change in emphasis has been a growing awareness that certain types of multiple rate systems may prove valuable adjuncts to economic development programs. In view of the fact that a number of systems, although originally only emergency measures, appear to be firmly entrenched and regarded by some governments as, in the long run, advantageous to nations employing them, it seems worthwhile to examine multiple exchange rates with particular reference to their relationship to the problems of underdeveloped economies.

[4] For a description and analysis of the multiple rate systems of Latin American and other countries see M. S. Gordon, *Barriers to World Trade*, New York, Macmillan, 1941, pp. 100-114; or League of Nations, *International Currency Experience*, Princeton University Press, 1944, pp. 162-189.

[5] Cf. League of Nations, *Report on Exchange Control*, Geneva, 1938, pp. 46-47.

[6] *First Annual Report on Exchange Restrictions*, *op.cit.*, p. 7.

[7] *Report on Exchange Control*, *op.cit.*, pp. 46-47.

After all, our thinking on the imposition of exchange controls on capital account—and even more so on current account—has undergone considerable modification in the course of the last decade; objections which were considered quite serious a few years ago have tended to be modified in the light of greater experience, and even exchange control on current account is now deemed fairly "respectable" under certain conditions.

In view of the changing emphasis and growing popularity that have recently characterized multiple exchange rate systems, there has been surprisingly little discussion of the impact of these devices in the academic literature of the last few years. E. M. Bernstein has given a brief but excellent systematic analysis of their economic effects, but has framed this in general terms rather than against a specific background of the process of economic development itself, the structure and institutions of underdeveloped countries, and the policy alternatives which are available to their governments.[8] The discussions of the auction market system of exchange control provide what is perhaps a more useful introduction to the relationship between multiple exchange rates and the structure and problems of economically less developed countries[9] —the critics of this particular type of multiple exchange rate structure having distinguished sharply between its relative effectiveness in industrialized and underdeveloped economies.[10]

Despite these occasional references to the problem in the literature, there has been no systematic attempt to analyze the applicability of multiple exchange rates to conditions in underdeveloped countries. This, therefore, is the purpose of the present mono-

[8] E. M. Bernstein, "Some Economic Aspects of Multiple Exchange Rates," International Monetary Fund, *Staff Papers*, Vol. I, No. 2 (September 1950), pp. 224-237.

[9] The principal proponent of the auction market instrument has been Robert Triffin. Cf. "National Central Banking and the International Economy," *International Monetary Policies*, Postwar Economic Study No. 7 (September 1947), Washington, Board of Governors of the Federal Reserve System, pp. 46-81; or "Exchange Control and Equilibrium," *Foreign Economic Policy for the United States* (S. E. Harris, Editor), Cambridge, Harvard University Press, 1948, pp. 413-425.

[10] G. Haberler, "Comments on 'National Central Banking and the International Economy,'" *International Monetary Policies*, *op.cit.*, pp. 82-102; H. D. Henderson, "The International Economy," T. Balogh, "A New View of the Economics of International Readjustment," and R. F. Harrod, "A Comment," all in *The Review of Economic Studies*, Vol. XIV (2), No. 36 (1946-1947), pp. 76-97.

graph, which seeks to discover to what extent, if any, our traditional distrust of these devices can be modified in the light of the exigencies of economic development.

In treating this question in the present monograph consideration has been almost entirely restricted to the effects of multiple exchange rates in the country which introduces them, and comparatively little analysis of their repercussions in the world at large is undertaken. That is, consideration has not been given to the question of whether the optimum pattern of exchange practices for countries taken singly would add up to the optimum pattern for the world at large. Let it be clearly stated that the nationalistic point of view is not the only appropriate point of view for economists to use in discussing international relations. The relation between the optimum pattern of resources and practices for nations taken singly and the optimum pattern for the world economy as a whole is a question of great importance, but, since it involves a consideration of such complex factors as the difference between static and dynamic patterns of resource utilization and the question of the over-all aims of the world economy, it falls beyond the scope of the present study.

A study of multiple exchange rate systems is seriously complicated by the fact that in many cases the countries that have employed them do not appear to have been fully aware of all their uses, nor to have obtained anything approaching the full benefits that can be realized from them. For this reason the principal aim of the present study is to determine the maximum benefits that a developing country can derive from multiple exchange rates under realistic conditions, with correspondingly less attention being paid to historical experience with these systems. Admittedly an approach of this kind tends to be somewhat abstract and theoretical, and some readers may not find the analysis as closely tied to actual systems as they may have hoped. But some choice between the two alternatives had to be made.

It has been found convenient to analyze the usefulness of multiple exchange rates on two different levels which correspond rather closely to two basic decisions which the government of a developing country must reach: their effects are compared (1) with those of other methods of interfering with the free working

of the foreign exchange market, and (2) with the opportunities for economic development under a free exchange market. The discussion begins with a consideration of the impact of multiple rates on the level and composition of imports; the effects of different types of systems are analyzed and then contrasted with those of quantitative restrictions and tariffs. With this as a framework we then proceed to investigate, from the point of view of economic development, the influences of multiple rates on the domestic price system, government revenues, capital formation, and the structure of production and to compare these to the impact of various other commercial, fiscal, and monetary policies. The next part of the paper analyzes the effects of different multiple rate systems on exports and foreign investment, while a fourth section discusses their impact on the geographic trade pattern and the relation of this to the problem of discrimination. Finally the various threads of the analysis are brought together in a brief over-all evaluation of the significance of multiple exchange rates.

Only those multiple rate systems which are unilaterally imposed are considered, and the analysis of individual systems has been restricted to Latin America. Thus, systems which are based on fixed differential exchange rates, the partial utilization of free market sales, the imposition of exchange taxes or surcharges, and the granting of exchange premia are included in the discussion; omitted are clearing agreements, intergovernmental barter agreements, and private compensation agreements; although these forms of exchange control also give rise to a pattern of multiple rates, cost restrictions and quantitative restrictions apparently are so closely related in the case of these devices that the *cost restriction* aspect cannot be separated out for examination. The decision to confine the analysis to Latin American systems[11] was in part the result of the author's special familiarity with that area; but to a larger extent, it reflects the conviction that, in view of the large number of Latin American countries which have employed multiple exchange rates, all the important varieties (as defined above) are covered.

[11] Descriptions of the particular systems that are analyzed can be found in the International Monetary Fund's *Annual Reports on Exchange Restrictions*.

II. Multiple Exchange Rates and Imports

The most immediate impact of the majority of multiple exchange rate systems has been on the level and composition of imports, which are known to be extremely sensitive to economic development programs, particularly when these programs take the form of more rapid industrialization. In view of the low capacity of underdeveloped countries for capital goods production, an increased rate of capital formation is usually reflected in a larger demand for imports of investment goods, while higher incomes and urbanization create a concurrent, or perhaps slightly delayed, expansion in the demand for imported consumers' goods;[1] in cases where the additional capital formation is partly or wholly financed by bank credit these "normal" developmental difficulties in the balance of payments tend to be greatly intensified by the resulting inflationary pressures.

Under these conditions governments of underdeveloped countries have frequently found it necessary to take measures to curtail imports of merchandise and invisibles.[2] Any action of this type necessarily implies that some decision has previously been reached with respect to a changed composition of imports. If the authorities decide to reduce imports by raising the income tax or depreciating the exchange rate, they have in effect concluded that any change in the composition of imports can be effected through the operation of the price mechanism and believe that this method of reallocating imports is in the best interests of the economy. In other circumstances, however, the government may believe that larger benefits may be achieved by interfering with the action of the price mechanism: for example, a smaller degree of adjustment may be necessary if depreciation is undertaken only with respect to imports with highly elastic demands; the long-run aim

[1] For a brief but comprehensive discussion of the "real income" effects of industrialization on the balance of payments, see J. H. Adler, *The Underdeveloped Countries: Their Industrialization*, New Haven, Yale Institute of International Studies, 1949, pp. 22-23.

[2] In the discussion which follows, the effects of multiple exchange rates on most nonmerchandise transactions are disregarded since it is believed that this does not change the results significantly; the treatment of interest, dividends, and profits under various types of multiple exchange rate systems is covered in a subsequent section (see pp. 50-53).

of economic development may be facilitated by granting special preferential treatment to imports of capital goods; or some other type of desired social rationing of foreign exchange may be achieved.

If it is decided to discriminate among different types of imports,[3] a decision must then be reached with respect to the technique or combination of techniques to be used in effecting the desired discrimination.[4] In making the selection account must be taken of a number of difficulties inherent in any discriminatory action that is taken to reduce the level of imports or alter their composition. The degree of interference with the price mechanism is important in this respect, as is the allocation of the scarce foreign exchange resources among competing importers. Closely related is the question of whether one sector or the entire economy is to obtain the benefits of the windfall profits which may be created by a restriction of imports. The certainty of the effects and the period of time that is necessary for them to be realized are also essential considerations, particularly in cases where the international reserves of a country are already quite depleted.

Selective curtailment of imports can, of course, be obtained by influencing either the local supply or the local cost of individual imports:[5] the government can limit supply through the imposition of quantitative restrictions, or it can reduce demand by increasing local currency costs through the introduction of multiple exchange rates or tariffs. If a combination of supply and cost restrictions is employed, only one device will actually curtail imports of any individual product, although the other may contribute certain refinements of technique that are necessary for overcoming some of the difficulties to which reference was made in the preceding paragraph. The relative merits of multiple exchange

[3] The merits and rationale of selective treatment of imports are evaluated in the next section; for the present it is assumed that a favorable decision has been reached on this question.

[4] The term "discrimination" is used here in its general rather than economic sense, for the present section is concerned only with discrimination with respect to *types* of imports; consideration of discrimination with respect to *sources* of imports is deferred to the section on the geographical trade pattern.

[5] The maintenance of a fixed exchange rate through central bank purchases and sales of foreign exchange is also a form of interference with the price mechanism of the foreign exchange market, but this interference is not selective.

rates can best be evaluated by comparing their effects, on the one hand, with those of supply restrictions, and on the other, with those of the tariff—the other major type of cost restriction.

Effects of a Simple Multiple Exchange Rate System

The two principal advantages of quantitative restrictions as an instrument for limiting foreign exchange disbursements are the comparative certainty of their effects and the relative rapidity with which these can be realized. If a foreign exchange budget is introduced and strictly followed, there seems to be very little doubt that imports can be curtailed to the extent planned and that this result can be achieved immediately, or at least fairly rapidly.[6] The use of foreign exchange budgets is, of course, a comparatively recent development, exchange control having formerly been a haphazard procedure of introducing a few controls at a time. Yet even when a budget is used, there tend to be complaints of hardship and requests for special treatment for goods already in transit; exemptions may be granted, and time may elapse before the entire system of restrictions is finally put into effect.

The major difficulties inherent in quantitative restrictions arise because the allocation of exchange among different uses and among the various importers is *entirely* a function of administrative decision. Foreign exchange is distributed in accordance with the authorities' views of the real needs of the economy, and the chances that this procedure will produce more beneficial results than the price system depend to a large extent on the ability and honesty of the administrators. In the absence of a sufficient number of highly trained and competent technicians, a condition which is particularly prevalent in underdeveloped areas, the authorities are likely to make some serious errors of judgment in the allocation of exchange. If the administrators are also corrupt, the distribution of exchange and import licenses among

[6] The curtailment of imports by any method always involves some uncertainty, for a decision must be made with respect to the degree to which imports have to be restricted. Because of the difficulties involved in estimating future import prices or foreign exchange receipts, there is always a rather large element of doubt that imports will be curtailed to the extent that is "necessary," but in the case of quantitative restrictions there appears to be very little uncertainty that they can be curtailed to the extent that is "planned."

importers may be largely determined by graft and favoritism, a circumstance which is likely to arise in some of the economically less developed countries as a result of the high propensity to bribe that is created by the windfall profits[7] that are available to importers who obtain licenses. When the quantitative restrictions take the form of exchange controls, moreover, maladministration may also give rise to the postponement of the processing of applications and the effecting of payments abroad, thus causing costly delays, and perhaps higher prices, for the domestic consumer and at the same time leading to a deterioration of the external credit of the country.

The use of multiple exchange rates avoids many of the difficulties which are created by the existence of windfall profits and the danger of incompetent or dishonest allocation of exchange, but these advantages are gained at the expense of greater uncertainty and slower appearance of the effects on imports. The government, as in the case of quantitative restrictions, influences the composition of imports, but in doing so it merely raises the domestic currency costs of nonpreferred imports by introducing less favorable buying rates or imposing exchange taxes and surcharges; preferred imports continue to enter at the existing exchange rate. Since the authorities have at best only an uncertain knowledge of the elasticities of supply and demand for various types of imports, they may not set the penalty rates high enough to curb imports sufficiently or may place too many products in the preferred category. Moreover, because the effects of the new rates will be felt only after the market has adjusted itself to the changed circumstances, the reduction of imports may not occur for some time. Both of these factors would lead to a continued loss of international reserves—a contingency which would be very unfortunate in the cases of countries whose exchange resources were already substantially depleted prior to the introduction of the multiple rate system.

The distribution of exchange among competing importers is a function of the price mechanism rather than administrative

[7] Windfall profits may, of course, be eliminated by the introduction of proper controls on domestic prices when they are workable and enforceable. See, however, p. 20 below.