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# The Splitting of Exchange Rates

by Dieter Friedrichs, Hamburg

All currency political measures must be regarded from two points of view: How do they affect the country's balance of payments? Which influences do they exercise on its internal economy?

The second question is of particular importance to many developing countries whose foreign trade yields a large share of their national income; it is all the more important in cases where measures of positive value to the balance of payments adversely affect the internal economy or vice versa. One method of avoiding these conflicting influences is to differentiate between various rates of exchange. This method, which used to have more advocates than it has today, operates as follows: A uniform exchange rate no longer exists; instead different exchange rates apply to all transactions. They are settled according to the kind of commodities involved, their importance to the balance of payments, the countries in question or their currencies.

To judge by the diminishing number of countries which go in for such exchange rate manipulation it may be assumed that this practice is on the wane. Take all the members of the International Monetary Fund (IMF), which means leaving out of account the states of the Eastern bloc: Between 1945 and 1966 forty-two of the IMF member states had recourse in some form or another to differentiation in their exchange rates. By September 1952 their number had dwindled to 22. At the present time exchange differentiation is still being practised notably by Chile, Costa Rica, Ecuador, Indonesia, Columbia, Uruguay, and Venezuela.<sup>1</sup> It may be safe to assume that multiple exchange rates will soon have disappeared completely. Such development would be altogether in accordance with the policy of the IMF, which makes the introduction and retention of discriminatory currency regulations and multiple exchange rates subject to its express approval (Article VIII, Paragraph 3 of the Fund's statutes.)

## Definition and Types of Multiple Exchange Rates

Multiple, split or differentiated exchange rates exist only if there is for one unit of a foreign currency in effect more than one legal buying and/or more than one legal selling rate in terms of internal currency units or if the authorities decree that the buying or selling rates should deviate by more than one

per cent from the official parity. The differentiation may be effected according to groups of commodities (for example capital and consumer goods, luxury and essential goods); it may take place according to currency areas (states) or to balance of payments categories (for example according to whether the transactions apply to goods or capital.)

To introduce multiple exchange rates requires first of all foreign exchange management and centralisation of all foreign exchange transactions in the hands of the state or of a state-controlled central bank as well as control and supervision of the entire foreign exchange trade.

In principle it is possible to distinguish between four ways of creating multiple exchange rates:

□ The monetary authority lays down for the incoming and/or outgoing foreign exchanges in each case two or several fixed rates.

□ Apart from fixed rates applicable to certain transactions, there exist also fluctuating rates which are arrived at on a so-called "free" foreign exchange market in accordance with supply and demand. This is the case for instance when exporters must sell only part of their foreign exchange revenue at the official fixed rate but are allowed to offer the remainder on the free market. There they obtain the rate of the moment according to the then prevailing demand; the amount realised may therefore vary.

□ Deviations from the uniform rates are effected by direct additions or deductions either by way of a special duty on foreign exchanges:

When for instance foreign exchange is required for specific purposes such as private travel abroad, a duty is imposed, and this creates a second exchange rate, different from the official one;

or a system of premiums is introduced:

In such a case the official rates are raised to a higher or lesser degree according to the type of imports and exports in question with the result that several different exchange rate levels come into being. To arrive at the true rate of exchange exporters must take into their calculation the premium they are entitled to, while importers must allow for the extra charge they are liable for. In such circumstances deviations by more than one per cent from parity are not infrequent.

□ Finally there still remains the possibility of indirectly influencing exchange rates by means of foreign exchange certificates or auctions. In the first

<sup>1</sup> Other countries, but of secondary importance, mentioned by the German Federal Bank are: Hongkong, Laos, South Korea, South Vietnam and Syria. See: "Die Währungen der Welt" ("The Currencies of the World"), published by the German Federal Bank, Frankfurt/M., Sept. 1966.

case different exchange rates result from the fact that foreign exchange for all or certain imports may be acquired only by submitting appropriate exchange certificates. Thus, according to supply and demand, fluctuations in the exchange rates occur because the importers of these certificates must buy them outright, or obtain them by bidding for them at an auction.

Where the auction system applies, selling rates vary. All import goods for which no fixed rate is laid down—for all "essential" imports the rates are fixed—are auctioned from time to time at special public sales. According to how urgently the country's consumers or producers need them these imported goods may still be divided into various categories, for which varying minimum bids may be laid down. For each category there thus results yet a different and temporarily fluctuating rate.

In reality, these systems rarely occur in their pure form. They are mostly combinations and mixtures of them so that a multiplicity of variants may exist.

### Thoughts on the Introduction of Multiple Exchange Rates

The decision in favour of a system of differing exchange rates is taken with the following five aims in view—aims which are not always explicitly stated:

#### ☐ Improvement of the balance of payments.

Difficulties arise over a developing country's balance of payments in the course of its industrialisation programme which it considers necessary. The amounts of foreign exchange required for the import of capital goods exceed those obtained from exports. Exports practically set a limit to industrialisation.<sup>2</sup>

To check ever rising deficits means must be found to increase the value of exports and/or lower the value of imports. From the currency political point of view it would be feasible to achieve this by means of a strong uniform devaluation. However, such a measure is hardly suited for developing countries whose situation is insufficiently stable, for such a measure would further strengthen the trend towards inflation which exists in any event in the country bent on devaluation. In terms of the internal currency imported goods would generally become more expensive and the price level would rise; exporters would obtain more for their goods and would through their own increased demand likewise exercise an upward pressure on prices.

An alternative suggestion is to devalue only the exchange rates for certain imports, while leaving those for other imports and also for exports unchanged. By this means these "devalued" imports<sup>3</sup> diminish in quantity while at the same time their price in terms of foreign currency falls<sup>4</sup> with the result that the

import value in foreign currency would drop. Pressure on the balance of payments would thus be alleviated. For which part of imports a special, higher rate should be fixed depends on the ideas the political economists have about how the internal production structure should be shaped.

#### ☐ Attainment of an optimal production structure.

In theory it is possible to apply exchange rate differentiation as a means of exploiting a country's import capacity to the best advantage. Imports which the development programme considers to be of particular importance for the country's economic growth such as the import of capital goods can be given preference via the exchange rate, whereas foreign exchange for the import of "luxury goods" can be sold at a higher rate. Such a selective fixing of the rates helps to limit the import of "non-essentials" and to facilitate the import of investment goods required for the country's industrial development ("essentials").

Looked at from the point of view of exports, it is possible to create through different rates of exchange inducements for the production of certain export commodities. The aim is to diversify exports, to make developing countries independent of the one-sided and frequently violent fluctuations in the export of their single-crop products (mostly raw materials) and to enable them also to export industrial goods. The much discussed deterioration in the terms of trade could in this manner be checked and perhaps even reversed.

#### ☐ Protection of home industries.

In order to protect home production from "cheaper" foreign competitors in the home market the splitting of foreign exchange rates is used as follows:

Foreign commodities in competition with developing home industries are made more expensive by burdening them with higher exchange costs. The price of these goods rises in terms of the internal currency—the degree of this price increase depending on the elasticity in the supply and demand situation on the market for these goods—with the result that their price advantage diminishes or disappears completely. Internal demand turns more towards home products, whose output can then be increased. This arrangement is intended only for a certain interim period until such time as productivity has risen, costs have been reduced, economies of large scale and external economies have been achieved.

#### ☐ The raising of state revenues.

As is well known, one of the pre-conditions for the introduction of multiple exchange rates is that the entire foreign exchange trade is in the hands of the state or of a state-appointed central organisation (state bank). The proceeds from the splitting of exchange rates (the selling rate is higher than the buying rate) represent state revenue with whose aid the public debt could be diminished. In this manner

<sup>2</sup> See H. Hesse: "Der Außenhandel in der Entwicklung unterentwickelter Länder" (The Part Played by Foreign Trade in the Development of Underdeveloped Countries), Tübingen 1961, p. 78.

<sup>3</sup> Provided the developing country's import demand is not completely inelastic.

<sup>4</sup> If the volume of foreign goods on offer is not completely elastic.

the budget deficit is reduced and at the same time a possible source of inflation is stopped up. Apart from this, there are certain windfall profits accruing to the state through the system of multiple rates—profits which would otherwise have benefited the importers and exporters because of the market situation (monopoly). These revenues can also be used by the state for, among other things, capital investments to facilitate industrialisation. This has two advantages:

If these investments were to be financed by credits, the effective demand would rise more than the inelastic offer, and intensified inflation would be the result;

furthermore public investments supplement private investments which are insufficient because they represent insufficient private savings.

#### □ Increased savings.

Multiple exchange rates are used as follows to increase the domestic volume of savings: By devaluing the exchange rate applicable to luxury goods these are rendered dearer, the volume of demand for them diminishes, and the expenditure on them can possibly also decrease according to the price elasticity of the demand. These reductions in household expenditures lead in part to savings because the original buying plans can no longer be realised.<sup>5</sup> Whether or not there will be an increase in total savings, ultimately depends on how the state disposes of its foreign exchange revenue.

### The Advantages of Multiple Exchange Rates

Apart from the above-mentioned rather theoretical advantages which differentiated exchange rates offer over quantitative restrictions of foreign trade, they have yet another merit. This is that they make use of the price mechanism and the market forces as the selective principle: Foreign exchange is allocated according to the buyer's preparedness to pay a higher price, and not according to his skill in obtaining a licence or a quota. Arbitrary decisions on the part

<sup>5</sup> H. Hesse: The Part Played by Foreign Trade in the Development of Undeveloped Countries, op. cit. pages 82.

of the foreign exchange control authorities are avoided, leaving no room for bribery and reducing administrative costs.

It is true, customs duties, taxes and similar impositions also influence the price mechanism, but in comparison with multiple exchange rates they have the disadvantage that they can be made effective only after long drawn-out parliamentary discussion and decision taking. Discriminatory exchange rates, on the other hand, are a matter for the executive to decide which renders their application highly flexible and makes it possible to carry out rapid adjustments to changed circumstances.

Quantitative measures frequently have the result that because of the effective and permanent protection they afford from foreign competition luxury goods industries are created at home, and this means that the existing output potential is not put to the best use, but wasted on purposes which do not facilitate growth. This is a drawback which can be avoided by using multiple exchange rates.

Protection of home industries through currency political means is in any event an interference with international competition. This interference is from the consumer's point of view less harmful, if multiple exchange rates are applied instead of quantitative restrictions, and for this reason: In spite of the fact that the foreign competitor carries a heavier burden through the unfavourable exchange rate the producer at home of import substitutes must always reckon with the possibility that the foreign producer by increasing his output may succeed in lowering his price and thus attract the internal demand. Quantitative restrictions, on the other hand, have a dangerous tendency to last and may possibly result in losses to the home economy.

### The Disadvantages of Multiple Exchange Rates

The above-mentioned advantages of multiple exchange rates notwithstanding, there are also some disadvantages, and it still remains to be seen which outweigh the others. Is it perhaps due to the disadvantages that multiple exchange rates are losing ground and tend to be gradually abolished?



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Pre-requisites for a smooth functioning of a split exchange rate system are the following:

- ☐ internal monetary stability,
- ☐ realistic adjustments of the individual rates in accordance with the elasticities shown by supply and demand and
- ☐ maintenance of only a few rates and for longer periods without frequent alterations.

The cases in which these pre-requisites exist in developing countries are extremely rare.

There is hardly a developing country that does not suffer to a higher or lesser degree from a depreciation of its currency. This applies notably to the Latin-American countries—the very countries in which multiple exchange rates used to play—or still play—an important part. Inflation very quickly destroys the beneficial effects derived from multiple exchange rates, for the initially “correct” rates soon become overvalued so that their intended effects—to curtail imports and facilitate exports—are diminished. In cases where monetary stability is lacking, the extent of the differentiation exercised through the exchange rates soon proves to be too small so that adjustments to the new situation become necessary.

This leads to considerable uncertainty among the parties interested in the country's foreign trade. Frequent changes in the rates also lead to intensified short-term speculation, making it more difficult to reach the desired objectives.

To differentiate between various rates “correctly” is in any event feasible only in cases where exact knowledge exists about the elasticities in the supply and demand situation for the commodities in question and about any subsequent changes in the situation. To differentiate too little or too much is equally bad in its effects, for the twin aims—industrialisation requiring assisted imports and the equalisation of the balance of payments requiring import restrictions—are in conflict with one another. Quantitative restrictions admittedly avoid the problem of elasticity nor do they lead to intensified speculation, but they have other great drawbacks such as the absence of the price mechanism, arbitrariness on the part of the authorities and the creation of chance profits.

Advantageous exchange rates are protectionist in effect and do not lead to the establishment of viable industries, able to stand up without protection against competition. The danger exists that, as in the case

of quantitative restrictions, productive forces deprived of incentives to growth are kept in a state of inefficiency.

Another point any policy of multiple exchange rates must consider is the so-called “ostentation” effect. This occurs when people—notably those in the higher income groups—prompted by ostentation and emulation take to buying “inessential” and for the most part imported luxury goods although they are more expensive, carrying as they do the burden of an unfavourable exchange rate. Where this happens, measures designed to influence prices such as customs duties, taxes and exchange rates are powerless to improve the balance of payments or to alter the import structure or to increase internal savings.

Multiple exchange rates must therefore always remain a relatively rough-and-ready instrument because they do not permit such detailed differentiation as is for instance possible with lists of customs duties providing for a different rate for each specific commodity. To lay down a special rate of exchange for each particular commodity is a practical impossibility.

Finally, discriminating exchange rates require for their application and control large bodies of officials and a good administrative system. These administrative pre-conditions are lacking in many developing countries with the result that unofficial dealings at black-market rates take place, proof of insufficient official control over foreign exchange transactions. This in turn means uncertainty, misdirection of resources, losses for the economy as a whole as well as shrinkage in the possible volume of trade and diminishing advantages accruing from the international division of labour.

### Conclusions

The system of multiple exchange rates thus has serious disadvantages, which become even graver in some developing countries where there is a combination of several unfavourable factors. Such factors are: Inflation, insufficient savings, irrational behaviour on the part of private economic subjects as well as the state, intense speculative activity, ponderous officialdom and the like. Where such conditions obtain multiple exchange rates are therefore not to be recommended and should where they exist gradually be discontinued. The present analysis has shown that differentiated exchange rates offer no such overwhelming advantages over other means of influencing foreign trade as to make them recommendable.



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It is after all common knowledge that it is impossible to give a general answer to the question of what constitutes the best foreign trade policy and what combination of means is the most likely to succeed, for the problems to solve differ from country to country. Nor is the following statement new, but its truth is very often ignored:

Recommendations concerning foreign trade policy are by themselves insufficient to solve the problems confronting the developing countries; efforts in the field of foreign trade policy must be sensibly supported by measures at home, that is to say they must be harmonised with each particular country's monetary, financial and budgetary policy, with its policy of employment and production and its income policy.

## *World Business Trends*

*Department for Business Trends Research,  
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### *Western Europe: Check to Business Activity*

So far in 1967 the West European economic trend was largely characterised by a check to economic activity. Although the Federal Republic of Germany alone experienced a distinctive recession, only Italy and Norway, on the other hand, showed a vigorous growth rate still. In almost all countries a retarding expansion of demand affected investments as well as consumption. However, welcome stimulations of production and creation of incomes in Western Europe originated from the development of goods trade with economic areas outside Europe.

So much the more remarkable is the cyclical stagnation of West European industrial production now lasting since the beginning of 1966. First this had been only a reflection of declining production in the Federal Republic and Britain, the most important economies. In the current year, however, industrial production in almost all countries—with the already mentioned exceptions—reflected more or less distinctly the cyclical slackness of the market. Therefore in the first half of 1967 the previous year's corresponding volume of production was not surpassed anywhere in Western Europe as a whole. The unusualness of such a stagnation is shown best by the fact that in the sixties West European industrial production never rose less than by 4 per cent annually.

The expansion of productive capacity continuing also with de-

clining investment activities—although at a lower rate—in this situation necessarily resulted in a generally reduced utilisation of capacity in Western Europe, i.e. in a declining productivity of the capital employed. Simultaneously the growth of labour productivity—without a reduction of labour employed—would have come to a stop. The available data reveal that therefore in several countries the entrepreneurs proceeded to a reduction of weekly working hours. But above all the number of persons employed in industry has been reduced.

This kind of reaction is by no means an unusual tendency in Western Europe, but also formerly it was as a rule one of the reliable indicators of an easing of cyclical conditions. Conspicuous, however, is the large volume of reductions in the number of employees. According to the latest data available—in the main for labour in industry as a whole—the number of persons employed with 7.7 per cent declined most in the Federal Republic of Germany, but after all the reductions reached between 3.5 and 5.6 per cent in the Netherlands, Austria, Britain and Sweden. It was less pronounced in France and Switzerland with 1.2 and 1.8 per cent, respectively. In Norway and Italy, on the other hand, the diverging business trends became apparent by the fact that they were the only countries still showing an increase in the number of persons employed in industry.

The discharges of persons employed in industry permitted a considerably improved supply of labour in all other economic sectors. Therefore in almost all countries the total vacancies for workers—taking into consideration the usual seasonal influences—declined in the course of 1967, and according to most recent data were frequently considerably smaller than a year ago. This applies e.g. to the Federal Republic of Germany, Britain, the Netherlands and Sweden. In this connection, it is true, not only the increased availability of labour had its consequences, but in part also the relatively hesitating labour management in non-industrial sectors, that in view of the force of the recession also felt strongly the decrease in demand.

Since spring in most of the West European countries only the usual seasonal stimulation prevented an increase of unemployment under these circumstances. During the summer-months the unemployment ratio adjusted for seasonal variation amounted to between 2 and 3 per cent in the Federal Republic and the Netherlands—for years distinguished by over-employment—and in Britain. For structural reasons alone this ratio was higher in Belgium and Italy. Thus full employment is jeopardised in important West European countries, as the "traditional" 3 per cent limit is hardly a recognised standard anymore.

The change in the labour market became particularly noticeable as regards the employment of foreign