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Effects of the Realignment on LDCs

by Dr Hans-Eckart Scharrer and Klaus Köhler, Hamburg *

The Washington Realignment aims at adjusting the distortions of exchange rates which have arisen during the past years. In doing so, new data have been set for the future. These data have been fixed by the industrial countries. The less developed countries (LDCs) are affected thereby without having had the possibility of exercising an influence on the agreement.

A considerable bottleneck for the economic growth of the LDCs is their limited import capacity of investment goods. Its determinants are, above all,

- ☐ the level of export proceeds,
- ☐ the purchasing power of export proceeds,
- ☐ the real burden of debts, and
- ☐ the real value of monetary reserves.

In order to appraise the situation of the developing countries, it is necessary to study the effects of the realignment on these determinants.

Important for the LDCs are practically only the parity changes of the industrial countries' currencies vis-à-vis each other. These changes determine the LDCs' trade situation as well as the real value of their foreign debts and monetary reserves. The parity changes made by some LDCs in the course of the realignment are relevant almost exclusively to their domestic markets; the prices quoted in foreign currencies for raw materials, their dominating export products, are not influenced thereby.

Minor Stimulation of Exports

The export proceeds of developing countries depend upon

- ☐ their export volume. Its most important determinant is the real income (real GNP) of the industrial countries: The higher the real income, the greater is the demand for export goods from developing countries.
- ☐ the prices of their export goods. Of special interest are the prices expressed in convertible foreign currencies (US \$, £-Sterling, DM, etc.).

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Since the major part of export proceeds originates from sales of raw materials, the most important aspect is how the realignment affects raw material proceeds.

As to the long-term effects, the realignment improves the conditions for a steady, and possibly also accelerated economic growth in industrial countries:

- ☐ The foreign trade risks (risk of parity changes, risk of the introduction of new tariffs and other trade impediments, etc.) are reduced. This stimulates investment activities.
- ☐ The reallocation of resources according to the more "realistic" price structure increases the efficiency of production.
- ☐ The economic policy is given more freedom for a steady management of the domestic economy: The realignment has reduced the necessity of abrupt and heavily dosed interventions in order to counteract a balance-of-payments deficit or to neutralise external inflationary tendencies (imported inflation).

These effects are hardly quantifiable. On the whole, they would seem to have a slightly favourable effect on the demand for raw materials.

In the short run, the demand for raw materials depends on the cyclical development in the industrial countries. However, since full employment and full utilisation of the production capacities can, in principle, be safeguarded by economic policy measures, the cyclical influence of the realignment is probably small:

- ☐ The direct effect on the business conditions in the USA is insignificant since the foreign-trade share in the US-GNP, being some 5 p.c., is negligible. But there is an indirect effect in so far as

the devaluation of the dollar facilitates an expansive economic policy. The upswing to be expected should produce an increased demand for raw materials.

☐ In Europe and Japan the realignment tends to slow down the business cycle. In consideration of the present cyclical situation it is not to be expected that the demand for raw materials will expand above average in the near future.

All in all, the realignment has brought about a long-term improvement of the conditions for achieving adequate economic growth in the industrial countries and thus promotes the sale of raw materials, though to a small extent only. Essential impulses of demand for raw materials can, however, hardly be expected in the prevailing cyclical situation.

Insufficient Rise of Export Proceeds

When the export volume is (nearly) constant, the change of export proceeds depends on the changes in raw-material prices. In the following it is assumed that these prices are quoted in dollar (considerations based on other currencies lead to the same results).

With given raw-material prices at the outset, it could be expected that prices in non-dollar currencies would fall by the relevant rate of revaluation vis-à-vis the dollar. Any price reduction induces, however, increases in demand in the countries concerned—especially in Western Europe and Japan—which prevent a lowering of prices by the full margin.

It is true that the old price level (calculated in non-dollar currencies) cannot be maintained either. This would imply that the dollar prices of raw materials rise by the dollar devaluation rate. But as any price increase reduces demand in the USA, prices cannot rise to this extent.

As a result, the raw material prices on dollar basis may rise (and fall on non-dollar basis), but not by the full rate of devaluation (rate of revaluation). With (approximately) unchanged sales quantities the dollar export proceeds of the developing countries will, therefore, not increase by the full rate of dollar devaluation.

The statistical material available so far seems to confirm the above-mentioned considerations. The HWWA Index of World Market Prices of Foodstuffs and Raw Materials (on dollar basis) rose

☐ from February 1971 (i.e. before the floating) till February 1972 by 11.4 p.c. (foodstuffs: + 10.1 p.c., industrial raw materials: + 12.1 p.c.);

☐ from December 1971 till February 1972 by 6.0 p.c. (foodstuffs: + 9.7 p.c., industrial raw materials: + 4.4 p.c.).

It is difficult to judge, however, in how far this rise is actually attributable to the realignment. Among other things it has to be taken into account that during the currency crisis orders for raw materials were placed cautiously, and stocks are now being replenished and built up to a larger extent. In addition to this, the price level is affected by heavy special movements of certain raw materials (e.g. December till February: sugar + 42 p.c., wool + 17 p.c., cocoa + 13 p.c.).

Purchasing Power of Exchange Proceeds

The purchasing power of the developing countries' foreign exchange proceeds is changed by the realignment

☐ because with given prices in national currencies, the industrial countries' export prices, expressed in dollar (or another standard currency), are altered according to the exchange rate correction vis-à-vis the dollar (or the reference currency, respectively);

☐ because the development of export prices expressed in national currency is itself affected by the realignment.

If the (dollar) prices of raw materials are not increased by the full rate of the dollar devaluation and, on the other hand, the dollar prices of the goods exported by the industrial countries are fully adjusted to the relevant parity change vis-à-vis the dollar,

☐ the real value of the LDCs' export proceeds declines in terms of imports from the non-dollar area: In order to be able to maintain a certain volume of imports from European countries and Japan, they have to export larger quantities;

☐ the real value of export proceeds rises in terms of imports from the USA: A given volume of raw material exports enables larger imports of American goods.

The net effect of the change in the purchasing power of foreign exchange proceeds, therefore, depends on the regional import structure of the relevant developing country.

For the whole of the developing countries the effect is unfavourable, since they obtain only approximately 20 p.c. of their imports from the USA, whereas nearly 50 p.c. of their imports originate from Western Europe and Japan.

The regions affected most by this loss of purchasing power seem to be Africa (only 8.8 p.c. of the imports stem from the USA) and South East Asia (24.0 p.c. of the imports stem from Japan, the country with the highest revaluation rate). The region affected least is Latin America, which bought 34.5 p.c. of its imports in the USA. (The possibilities of the LDCs to adapt their regional import structure to the new data set by the realignment are very limited).

The result is modified when the price developments in the industrial countries are also taken into account. By the realignment the prospects for greater price stability tend to

- ☐ have improved in Europe and Japan;
- ☐ have deteriorated in the USA.

Table 1
Regional Import Structure of the LDCs in p.c.
of Their Total Imports
(First Half-Year 1971)

Imports from of	World	Developed Market Economies			
		Total	Europe	USA	Japan
LDCs including:	100	72.9	32.6	20.1	14.1
Africa	100	77.5	53.3	8.8	11.2
Latin America	100	76.7	30.7	34.5	7.3
Middle East	100	67.8	41.8	16.1	7.2
Rest of Asia	100	70.4	19.2	21.6	14.0

Source: Calculated according to United Nations: Monthly Bulletin of Statistics, Dec. 1971.

Hence, the revaluation effect of the European currencies and the Yen, being unfavourable for the LDCs, is at least partly cancelled out by the gain in price stability. In the short run, a stabilisation of export prices, expressed in national currencies, is noticeable, whereas due to the exchange-rate changes the export prices on dollar basis have increased considerably in Western Europe and Japan.

From the first quarter 1971 till November 1971 export prices in national currencies (and on dollar basis, respectively), rose in p.c.:

- ☐ in Great Britain by + 5.8 (+ 9)
- ☐ in France by + 4.6 (+ 5)
- ☐ in Germany by + 1.9 (+ 11)
- ☐ in Italy by + 1.7 (+ 4)
- ☐ in Japan (October) by + 0.9 (+ 9)
- ☐ In the USA export prices did not rise.

Since during the period under review the exchange rates were allowed to float to some extent, the emerging tendency with regard to the prices

quoted in national currency may be taken as an indicator for the price changes to be expected from the realignment.

A decline of the inflationary trend may also be achieved long-term. The scope of price stability provided by the realignment must, however, be utilised by the monetary authorities. Even if this is done, the gain in stability will only gradually be realised over a longer period.

External Debt

The realignment does not affect the nominal value of the developing countries' foreign liabilities, expressed in the currencies of the creditor nations. However, the fact that interest and redemption payments have to be made in foreign currencies out of future foreign exchange receipts, changes the burden of real debts, i.e. the equivalent in goods which has to be sold abroad for redemption purposes.

When proceeding from the assumption that the raw material prices on dollar basis do not rise to the extent of the dollar devaluation (i.e. that prices in other currencies drop), the effect is as follows:

- ☐ The real value of dollar debts decreased by the percentage of the price increases for raw materials.
- ☐ The real value of debts in other currencies increased by the revaluation rate of the relevant currency vis-à-vis the dollar, less the rise of raw material prices.

A decisive factor for the debts position of the LDCs is therefore not only the price development of raw materials but also in what currencies their foreign liabilities are denominated.

The debts of LDCs are made up by export credits, bilateral government loans and loans from international agencies. It may be assumed that export credits and bilateral credits are payable in the currency of the creditor nation, whereas credits of international organisations are mostly granted on dollar basis.

Under this assumption it appears that of the new indebtedness incurred by developing countries from 1967 till 1969 approx. 40 p.c. are repayable in European currencies, approx. 44 p.c. in US \$ and roughly 16 p.c. in Yen.

When taking these shares as an indication of the LDCs' debt structure, a comparatively small negative net effect on the debt position may be expected.

This effect will greatly differ from country to country. Economies having to repay considerable Yen debts (mainly South East Asia) suffer most. Countries whose debts are predominately fixed in dollar, are in the most favourable position. Owing to increased export proceeds, these countries may even experience an advantageous net effect on their debt situation.

These effects caused by the realignment are evident not only in respect of the existing burden of debts but also with regard to the LDCs' future indebtedness.

Monetary Reserves and Realignment

As monetary reserves represent a claim for foreign goods and services, their real value, i.e. purchasing power, is changed by the realignment:

□ The real value of gold and special drawing rights has increased vis-à-vis the dollar by the rate of devaluation, has remained unchanged vis-à-vis some European currencies (£-Sterling, Franc), and has decreased vis-à-vis other currencies (DM, Yen).

□ The purchasing power of dollar reserves has deteriorated vis-à-vis all potential supply countries, except for the USA.

The realignment has reduced the real value of a country's monetary reserves the more, the higher the share of dollar reserves in the total monetary reserves is.

The monetary reserves of the industrial and developing countries are made up as indicated in

Table 2
Regional Composition of Monetary Reserves
In p.c. of Total Reserves
(Second Quarter 1971)

Region	Total	Gold	SDR	IMF Position	Foreign Exchange
Industrial countries	100	41	6	7	46
Developing countries including	100	16	5	5	74
Africa	100	8	4	3	85
Latin America	100	18	9	9	64
Middle East	100	26	2	2	70
Rest of Asia	100	13	5	5	77

Source: Calculated according to International Financial Statistics, January 1972.

When assuming that the major part of foreign exchange reserves consists of dollars, then the LDCs suffer a considerably greater loss than the industrial countries do. While the industrial coun-

tries, on an average, hold only some 46 p.c. of their monetary reserves in foreign currency, three quarters of the LDCs' total reserves consist of foreign currency. The share ranges from 64 p.c. in Latin America to 85 p.c. in Africa (the high foreign exchange reserves of the African countries probably consist to a considerable extent of "stable" sterling and franc accounts, so that the loss, in full, may not be higher than it is in other LDCs with a lower foreign-exchange share).

To what extent this real loss actually materialises in the individual LDCs depends on the currency areas in which a country will make use of its reserves. Vis-à-vis the USA, for instance, the real value of foreign currency has remained unchanged, the real value of the other monetary reserves has even increased.

Conclusions

The monetary realignment has had an unfavourable effect on the foreign trade situation of the developing countries. The real value of their export proceeds has declined, the burden of debts has gone up, and the real value of monetary reserves has decreased, and this even more than in the industrial countries.

A "deterioration" of the external position, however, ensues only from a comparison with the situation prevailing before the realignment. This situation was not a balanced one, but was characterised by exchange-rate distortions which favoured many LDCs as well as industrial countries. In so far the realignment has merely removed artificial foreign-trade advantages and not created disadvantages.

It is not possible to quantify the negative effects in general. A relevant attempt may be made in respect of individual countries only, taking their specific conditions into due consideration.

The negative consequences of the realignment affect one of the LDCs' weakest spots. A loss in international purchasing power means smaller import volumes and, thus, a setback in their efforts to build up a diversified export structure. But a wide range of export items is urgently required to enable the LDCs to free themselves from the fatal economic dependence on a few raw materials which, besides, are mostly jeopardised by substitution.

In building up this export structure the LDCs depend on the support given by industrial nations. Such assistance would have to comprise, besides financial aid, also, and above all, the removal of trade impediments to the LDCs' manufactured products.