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# Floating Exchange Rates and their Problems for the Developing Countries

by Barbara Erhardt, Hamburg \*

**The following article deals with the reasons for the fierce resistance of the developing countries to the system of floating exchange rates which the industrialized countries are favouring at present. It examines the consequences of floating exchange rates for the foreign trade, indebtedness and reserves of the developing countries and their implications for the situation in their domestic economies as a whole.**

The new Article IV of the Agreement on the International Monetary Fund which was adopted in Kingston in early 1976 has set the seal on what had been common practice: it laid down that IMF members may choose their own exchange-rate system. Floating exchange rates are thus no longer contrary to the IMF statutes<sup>1</sup>.

As a matter of fact nearly 60 p.c. of the world trade is transacted by countries which let their currencies float, either by themselves or in a block with others (cf. Table). A close look shows however that almost all of them are industrialized countries. Among the developing countries there are only four which engage in floating: most of the others have linked their currencies in some way or other to other currencies.

So it is quite obvious that developing countries take a different attitude to floating exchange rates than do industrialized states. In their catalogue of demands for a New International Economic Order they advocate stable rates of exchange not only for their own currencies but especially for the currencies of the industrialized countries<sup>2</sup>. The group of 24<sup>3</sup> objected to general legalization of floating<sup>4</sup>.

Why is it that an exchange-rate regime clearly in favour with the industrialized countries at the

present time encounters such fierce resistance from the developing countries? What particular problems ensue from flexible rates for this group of countries? How can the difficulties be countered? Could the problems be solved by a general return to fixed rates of exchange?

For purposes of analysis a distinction should be made between two cases — floating of the developing countries' own currencies and floating by the industrialized countries. The latter probably presents the developing countries at present with a bigger problem, for they have to face it but have no direct influence on it while they can take decisions, within given parameters, about the possible flexibility of their own currencies.

## Own Floating No Alternative

The most important argument against the introduction of flexible exchange rates in developing countries probably rests on the prospective repercussions on their foreign trade. The export trade of the developing countries is characterized by predominance of primary products: most developing countries derive the bulk of their export earnings from one or a few raw materials, and the prices of these are as a rule expressed in foreign currencies and determined outside their borders<sup>5</sup>. Their market power is low so that almost all their imports and exports are invoiced in one of the key currencies.

As a result of these particular conditions the developing countries, unlike the industrialized states, have little flexibility in their response to data changes which are brought about by floating. One has to distinguish here between the repercussions of exchange-rate fluctuations and those

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<sup>1</sup> Cf. Report by the Executive Directors to the Board of Governors, International Monetary Fund, Washington, D.C., 1976, Part IV, p. 6.

<sup>2</sup> Cf. Manila Declaration and Programme of Action, published in: United Nations Conference on Trade and Development, TD/195, Febr. 12, 1976, p. 22.

<sup>3</sup> The Group of 24 was appointed by the Group of 77 in 1972 so as to ensure consideration for the interests of the developing countries in the reform of the international monetary system. Cf. (no author) Fund and World Bank Prepare for Meetings in Manila, in: IMF Survey, Vol. 5 (1976), No. 17, p. 259.

<sup>4</sup> Cf. Intergovernmental Group of 24 on International Monetary Affairs, Communiqué, Tenth Meeting of Ministers, June 9, 1975, printed in: IMF Survey, Vol. 4 (1975), No. 12, p. 180.

<sup>5</sup> Cf. Carlos Federico Díaz-Alejandro, Less developed countries and the post-1971 international financial system, Princeton 1975, p. 2.

stemming from changes in exchange-rate trends. The uncertainties ensuing from exchange-rate fluctuations for the foreign trade can easily lead to a contraction of the trade of the developing countries. The exporters and importers run all the greater risks because the developing countries have no functioning forward exchange markets. They are without the technical and personal prerequisites for setting up forward markets whereas in the industrialized countries the profit motive would bring such markets into being if they were needed<sup>6</sup>. Moreover, the developing countries find the inconvertibility of their own currencies a hindrance when they want to carry out necessary compensation transactions in the international financial markets.

Attempts by public authorities in the developing countries to create the requisite facilities also have their problems: difficulties arise when the monetary authorities fix both spot and forward rates<sup>7</sup>. In certain circumstances they may incur considerable losses: if for instance they expect their own currency to go down in value but never-

theless provide carry-over facilities for foreign currencies at a low rate, they stand to lose if their currency is in fact devalued. In a few countries, such as India, the public authorities do however provide forward trading facilities for foreign currencies.

This is no doubt better than utter insecurity but foreign exchange guarantees involve costs which may militate against foreign trade. It may make things easier for private interests if there are fixed forward rates at odds with the market but they amount to a redistribution at the expense of the state which the latter cannot sustain for ever.

One general economic consequence of exchange-rate fluctuations is increased uncertainty about the level of imports which the developing country is able to finance with the foreign currency proceeds from its exports, for — other things being equal — the import potential depends upon the rate of exchange between exporting and importing country. This is a factor which can have repercussions on development planning.

Short-term fluctuations apart, floating exchange rates in developing countries must be expected to have a detrimental effect on the exchange-rate trend. In a system of fixed exchange rates, it is true, these states will also face the necessity of periodical exchange-rate adjustments. But they will be able to bring their influence to bear on the rate of devaluation so as to keep the price rise for foreign goods in their local market within bounds, for the higher cost of imports, especially food imports, which are essential to the developing countries may have grave consequences for their population. Moreover, the elasticities pertaining to developing countries are such that devaluation will as a rule neither help to expand exports nor reduce imports; hence the balance of payments will not improve as desired. It follows that in most developing countries exchange-rate modulations are not a suitable means of bringing about adjustments.

It is for these reasons that most developing countries consider floating an unacceptable device for their own currencies. Instead, they have linked their currencies to one other currency or else to a „currency basket“: the link is in principle rigid although exchange-rate alterations at certain intervals are not ruled out. Through links of this kind the developing countries hope to abate the negative consequences of unpegged exchange rates. How successful they have been in this will be examined in the following section.

<sup>6</sup> Cf. Harry G. Johnson, *Beiträge zur Geldtheorie und Währungspolitik* (Contributions to Money Theory and Monetary Policy), Berlin 1976, p. 202 f.

<sup>7</sup> Cf. (no author) *Developing Nations Need Wide Range of Policies to Adapt to Floating Rates*, in: IMF Survey, Vol. 5 (1976), No. 5, p. 71.

**Table**  
**Exchange-rate Practices of IMF Members<sup>a</sup>**  
(June 30, 1975)

	Number of currencies	p.c.	Percentage share of trade of all IMF members <sup>b</sup>
Currencies floating independently	11	9	46.4
of which:			
Developing countries	4	3	1.2
Currencies floating together	7	6	23.2
Currencies linked to one other currency <sup>c</sup>	81	66	14.4
of which:			
to the US dollar	54	44	12.4
French franc	13	11	0.4
Pound sterling	10	8	1.6
Spanish peseta	1	1	—
South African rand	3	2	—
Currencies linked to a group of other currencies, of which:			
SDR	5	4	5.0
other currencies	14	11	7.4
Currencies linked to other currencies at rates which are altered frequently according to a specified formula	4	3	2.0
	122	100	98.4

<sup>a</sup> The figures and percentage rates in this table must be regarded as approximate only as the exchange-rate systems do not all correspond precisely to the above categories. Four members (accounting for 1.6 p.c. of the world trade) have not been included in this table because it is particularly difficult to classify their exchange-rate systems.

<sup>b</sup> Imports plus exports in 1974.

<sup>c</sup> The use by an IMF member of the currency of another member has been classified in this table as establishing a link with the currency concerned.

Sources: Analysis of System of Floating Finds Strengths, Shortcomings, in: IMF Survey, Vol. 4 (1975), No. 16, p. 248; Developing Countries Faced with New Policy Questions with Rates Floating, in: IMF Survey, Vol. 5 (1976), No. 3, p. 35 ff.; Own calculations on the basis of data in International Financial Statistics.

If a developing country links its currency to one other currency, it thereby achieves stable though variable exchange rates with its principal trading partner (to whose currency the developing country normally links its currency) as well as those other developing countries which have linked their currencies to the same currency. The stability of the cross-rates between these countries is however of little importance as the intergroupal trade of developing countries is as yet of rather modest proportions.

Floating exchange rates between key currencies have no effect on a developing country as long as it trades with one particular country or currency area alone. In practice this never happens however nor would it be desirable. If a developing country engages in trade with third countries as well, floating rates of exchange between the key currencies engender uncertainties, for the exporter who has business dealings with third countries does no more know what recompense in his own currency he will receive for his exports than is the case if the currency of his own country floats, and the importer must also bear in mind that the cost of his imports is liable to vary in terms of his own currency.

In this case there exists however in principle the possibility of covering against the risk of exchange-rate fluctuations because it involves only two key currencies which are traded in forward markets. There remains of course the question whether the individual importer or exporter has access to the international forward markets.

If the rate of exchange between the currency of the developing country and that to which it is linked is subject to relatively frequent alterations — a condition applying to a number of countries — forward cover is needed also for the currency of the developing country. It is a great drawback in this respect that there are no forward markets for the currencies of developing countries.

Insofar as the link with another currency gives developing countries the possibility to cover forward risks, existing uncertainties are reduced but the instability of the exchange rates is not affected. The developing countries have less room for manoeuvre and are therefore in a much worse position for coping with the negative effects of unstable exchange rates — and consequent fluctuations in the prices of import and export goods in their own currency — than the industrialized states.

If the currency of a developing country is linked to another currency, its own exchange rate comes under the sway of factors bearing upon the other currency which may conflict with the general economic conditions in the developing country it-

self. If, for example, the exchange rate of the principal trading partner rises in relation to a third currency, the exchange rate of the developing country necessarily also rises even though its trade with the third country may be in deficit. As a result the developing country will run a greater risk in its planning.

As developing countries must strive to avoid exchange-rate instability as far as possible, the linkage with another currency often has the result that the trade of these countries is concentrated on one country or currency area although regional diversification could in certain circumstances reduce the cost of imports and/or increase the export earnings. Moreover, trade focalization is likely to curtail the potential for export growth, especially if the growth rate in the link country is below average.

### Inflationary Impulses

An argument often mentioned beside the danger of foreign trade focalization is that inflationary impulses in developing countries may be accentuated by the floating of key currencies. Inflationary tendencies do in fact exist in many developing countries because of an all-out growth and employment policy. This creates strains so that comparatively grave consequences may spring from slight additional inflationary pressure.

In the course of an inflationary development it could happen that the export trade is in part jettisoned and goods are produced instead for the local market. This will happen in the event of a relative shift in prices in favour of the domestic market. "The consequence is increased susceptibility of the economy to world market price fluctuations, for the goods left over for export are in the main raw materials and agricultural and mining products of low supply elasticity"<sup>8</sup>.

Inflationary impulses can flow either from short-term exchange-rate fluctuations or from a trend towards devaluation. In neither case can floating create additional inflationary pressure unless the developing country is trading also with third countries.

Short-term trend dispersions can accentuate the inflation if the importers cost their goods on the basis of average rates and these are above the trend average. Even if this is not the case, upward deviations of the exchange rates from the trend are capable of underscoring inflationary tendencies if the prices in the trade sector are resistant to downward movements<sup>9</sup>. The consequent reper-

<sup>8</sup> Rüdiger DoebeI, *Devisenbewirtschaftung und Wirtschaftswachstum in Entwicklungsländern* (Foreign Exchange Control and Economic Growth in Developing Countries), Frankfurt 1968, p. 110.

<sup>9</sup> For details cf. Wolfgang Wetter, *Inflation durch Floating?* (Inflation by Floating?), in: *WIRTSCHAFTSDIENST*, 56th year (1976), No. 1, p. 46 ff.

cussions on the price level will probably not be very strong however because the trade with third countries accounts only for a fraction of the total trade of a developing country. Besides, it is not certain that with pegged exchange rates the imported inflation would not be even greater because they would make it much more difficult, at the very least, for the industrialized countries to pursue a policy of stabilization.

Inflationary impulses may also derive from linking the currency of a developing country to a currency which has a tendency to depreciate: if this link currency floats downwards, the reason is presumably that the country concerned has a relatively high inflation rate. If so, the developing country will, on the one hand, import inflation directly and, on the other, experience an increasing diversion of the demand for foreign goods to domestic suppliers provided that the prices of imported goods rise above those of domestic alternatives. The scope for such diversionary movements is limited — especially for investment goods — but since bottlenecks exist in home supplies in any case, any inflationary tendencies are likely to be reinforced <sup>10</sup>.

On the whole however floating exchange rates are unlikely to have very strong inflationary effects: the foreign trade of the developing countries will therefore be affected by flexible rates to a limited extent only. There remains however a drawback of floating exchange rates in the industrialized countries of some significance for developing countries which have linked their currencies to that of their principal trading partner: they must put up with continual price fluctuations due to unstable exchange rates insofar as they trade with third countries; owing to the specific structure of their foreign trade their reaction to exchange-rate fluctuations cannot be as flexible as that of the industrialized countries. Focalization of their trade on the countries to which their currencies are linked is no satisfactory alternative because regional diversification of foreign trade is economically desirable.

#### **Link with a Currency Basket**

In view of the indicated problems larger developing countries whose foreign trade is more widely spread find it advisable to limit exchange-rate fluctuations in relation to all important currencies rather than one particular one. This can be done by linking the currency of the developing country to a currency basket which in practice usually reflects the structure of its bilateral trade relations <sup>11</sup>.

Several countries have linked their currencies to the Special Drawing Rights (SDRs). Since the change-over in 1974 the value of the SDR has

been determined by the weighted average of the 16 most important currencies <sup>12</sup>. That the SDRs in fact accurately reflect the foreign trade distribution of these countries is unlikely but they have the advantage that their value, unlike that of a "tailor-made" currency basket, can be easily ascertained as their rate of exchange in relation to all major currencies is published daily.

For limiting exchange-rate risks there is no advantage in linking a currency to a currency basket unless the country concerned has already achieved a wide regional spread of its foreign trade; for countries which are closely entwined with one trading centre the link with a currency basket causes more exchange-rate instability than a link to one particular exchange.

However, countries with wide regional trade diversification cannot eliminate the risks to their foreign trade altogether by linking their currency to a currency basket, for the fluctuations of the basket currencies will continue to affect the developing country — albeit only in proportion to their share of the basket — unless they cancel each other out.

The developing country must intervene itself if its exchange rate is to be kept stable in relation to the basket. But in distinction from the former system of pegged exchange rates — which imposed on all countries (except the USA) an obligation to keep the exchange rate of their own currency within certain parity bands — it has to bear the burdens of intervention by itself, with the result that its foreign currency requirements increase.

#### **Aggravation of Debt Problems**

A glance at the debt position of the developing countries shows what an encumbrance the need to hold more foreign currency for intervention purposes can represent. In the last few years in particular the debt burden has become increasingly oppressive for the developing countries. In 1975 it cost them an estimated US 14.6 bn to service their debts — as much as all developing countries together currently earn from all their exports in an average two-months period <sup>13</sup>.

In this situation any further aggravation of the debt position poses a serious problem for the developing countries. The floating of the key cur-

<sup>10</sup> Cf. Peter-Johann Schneider, Die Bedeutung der internationalen Währungsordnung und der vorliegenden Reformvorschläge für die Entwicklungsländer (The Importance of the International Monetary Order and the Existing Reform Proposals for the Developing Countries), Tübingen and Basle 1974, p. 132.

<sup>11</sup> Cf. Carlos Federico Díaz-Alejandro, *Ibid.*, p. 8.

<sup>12</sup> For a detailed account of the valuation of the SDR cf. (no author) Basket Valuation of SDR Takes Effect, in: IMF Survey, Vol. 3 (1974), No. 13, p. 209 ff.

<sup>13</sup> Cf. Gisèle Musy, Entwicklungsländer — Verschuldung ohne Ende? (Developing Countries — Indebtedness without End?), in: Der Monat in Wirtschaft und Finanz, 1976, No. 9, p. 3.

rencies can aggravate the situation only if loans have to be repaid in third countries. Short-term oscillations around the trend-line can give rise to foreign currency losses if the interest and redemption payments fall due discontinuously. Losses will be incurred if the payments have to be made at times when the current exchange rate is below the trend rate.

A trend-related devaluation caused by continual upward floating of the reference currency increases the amount of foreign currency needed to cover the foreign liabilities. As the depreciation bias of the link currency is in this case not due to economic conditions in the developing country, it follows that such losses would not occur if the exchange rate of the developing country were in principle fixed but variable.

The developing country does not need a larger amount of foreign currency to service its debts if it holds the loan currency in its reserves and can cover the interest and repayments from these reserves. The maintenance of reserves is therefore of increasing importance for the developing countries.

### Currency Reserve and Floating

The developing countries can use their own currency reserves to meet their foreign commitments as well as the foreign currency derived from export earnings, foreign loans, public development aid transfers and private investments<sup>14</sup>. Unlike the industrialized countries, the countries of the Third World are holding most of their reserves in the form of foreign currencies.

The grand total of a country's means of international payments should be large enough to cope with unexpected emergencies and allow at the same time a sufficiently flexible economic policy. Currency reserves of a certain size are, moreover, important for the credit standing of the developing country in the world: it has a bearing on the willingness of other states to provide the develop-

ing country with credits. It is not however in the interest of developing countries to accumulate excessively large reserves because of the opportunity costs involved in keeping reserves: the money kept in reserve would otherwise yield an income. In a developing country the marginal revenue derived from an additional dollar is probably higher than in one of the industrialized countries<sup>15</sup>.

Until now the developing countries have kept their currency reserves as a rule in the currency of the country with which they have the closest economic and political links<sup>16</sup>. In a world of pegged exchange rates this arrangement is functioning perfectly well. So it does in a system of flexible exchange rates if the trade and capital relations of the developing country are confined to the reserve currency country to which its own currency is as a rule linked. But if this is not the case, fluctuating exchange rates between the key currencies will have repercussions on the reserves kept by the developing country.

As well as an increased need for reserves for intervention purposes, which was mentioned already as a requisite of a currency linked to a currency basket, continual fluctuations of the value of the currency reserves must in this case be expected. Insofar as reserves are maintained in currencies which tend to depreciate, such as the pound sterling, the value of foreign currency reserves will decline continually<sup>17</sup>, and higher interest rates do not invariably make up for this.

<sup>14</sup> These include gold, foreign currencies, reserve items with the IMF and Special Drawing Rights; cf. Franz E. Aschinger, *Das Währungssystem des Westens* (The Monetary System of the West), Frankfurt 1971, p. 86.

<sup>15</sup> Cf. J. P. Agarwal, *Optimal Monetary Reserves for Developing Countries*, in: *Weltwirtschaftliches Archiv*, Vol. 107, Issue 1, Kiel 1971, p. 89.

<sup>16</sup> Cf. United Nations Conference on Trade and Development, *Fluctuating exchange rates and the developing countries*, TD/B/555, July 8, 1975, p. 6; henceforth quoted as "UNCTAD: Fluctuating exchange rates".

<sup>17</sup> Cf. Ronald Clapham, *Die Entwicklungsländer und die Reform des internationalen Währungssystems* (The Developing Countries and the Reform of the International Monetary System), in: *Beihfte der Konjunkturpolitik*, Issue 20, 1973, p. 162.

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Losses of this kind however would also occur in a system of fixed exchange rates if these are not absolutely inflexible.

Diversification of foreign currency reserves offers a possible solution because fluctuations of the value of the reserves become in practice only effective when the reserves have to be used for payments in a third currency. There are some technical difficulties which have to be overcome in this case<sup>18</sup> but these are not insuperable. If the reserves are diversified, recourse must be had to the Euro-currency market: in a few important cases this market offered the sole means of acquiring funds in one of the key currencies<sup>19</sup>.

An argument advanced against reserve diversification is that if a significant number of countries take a similar attitude, this will have the effect of inducing just those exchange-rate fluctuations which are to be avoided by this device<sup>20</sup>. There does not however seem to be a very great danger of this happening because a number of developing countries have already diversified their currency reserves; besides it is unlikely that the developing countries will take simultaneous action in future.

Diversification has however an undesirable side-effect: it necessitates an increase in the foreign currency reserves because a larger amount has to be kept in reserve in each of the currencies in question so as to cover unforeseeable developments. This can greatly add to the cost of maintaining reserves.

### **A Reasonable Demand**

The importance of the repercussions of flexible exchange rates which have been discussed so far derives initially from their implications for the domestic economic objectives of the developing countries and more especially the objective of growth. Not only does floating intensify the insecurity in trade, which may cause the foreign trade to contract or else not expand enough, but it aggravates the debt problem. Diversification of their currency reserves is a defensive device at the disposal of the developing countries but requires increased foreign currency holdings which will no longer be available to pay for the urgently needed imports. The consequence is all the more serious because foreign currency exiguities are one of the constraints which hinder the expansion of production in the developing countries.

The developing countries stand in need of considerable investments in order to mobilize existing resources and open up new ones. These in-

vestment goods can in great measure be obtained only in the world market. The realization of investment projects therefore depends essentially upon the possession of internationally liquid funds. Any measure which curtails the influx of foreign currencies is therefore bound to impair the conditions for development planning and plan realization, with the consequence that economic growth is retarded. This is true, albeit to different degrees, no matter whether the currency of the developing country is linked to one currency or to a currency basket. One can therefore understand that the developing countries are calling for exchange rates as a general rule to be fixed. What remains in question is whether this demand has any prospect of realization at the present time.

### **Practicability of a System of Fixed Exchange Rates**

The exchange rates have never been completely inflexible. In the state of world-wide economic integration reached by now, fixed exchange rates could only prevail permanently in the real and financial spheres if either the economic policies of the industrialized states were harmonized or the requisite measures of adjustment were taken by them in the domestic sphere. Neither of these two solutions is in accord with the balance of interests of the industrialized countries. A system of fixed rates which is subject to frequent and erratic disruptions however would not serve the best interests of the developing countries.

Fixed but adjustable rates of exchange would have an advantage over a system of rigidly pegged rates in that grave disruptions of the monetary system could be avoided by adjusting the exchange rates in good time. But revaluations and devaluations are an indispensable element of this system, which means that in the final analysis only such disruptions could be avoided as are caused by short-term fluctuations of the floating key currencies.

A reinstated system of fixed but adjustable exchange rates would probably prove quite realistic in the long term. In the short term however efforts to even out fluctuations by selective managed floating within a system of flexible exchange rates under IMF supervision may hold out a better prospect of success.

Whatever the shape of the dominant exchange-rate regime, it can only play a subsidiary role in securing the process of growth in the developing countries. Decisive are in the last resort the requisite structural changes which are needed to ensure an independent development of their economies attended by a sufficiency of foreign currency earnings. The developing countries have more than once given utterance to demands which are consistent with this aim.

<sup>18</sup> For details cf. Carlos-Federico Díaz-Alejandro, *Ibid.*, p. 8.

<sup>19</sup> Cf. UNCTAD: *Fluctuating exchange rates*, *ibid.*, p. 6.

<sup>20</sup> Cf. (no author) *Developing Nations*, *ibid.*, p. 71.