Managing The Exchange Rate in the Presence of
Foreign Exchange Shortage

by

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In recent years, a majority of developing countries have found themselves in the unhappy situation where the supply of foreign exchange to their central banks is insufficient to meet the demand at current official exchange rates. Over the years, countries have adopted a variety of strategies to cope with this situation, but recently there has been a preference for some form of steadily depreciating exchange rate. This preference has been encouraged by the unfortunate experiences of countries which have tried to ration the available foreign exchange using a variety of administrative measures. However, moving exchange rates have had problems of their own; in particular, they generate high rates of inflation in open economies and unless carefully managed they can lead to a spiral of increasingly rapid inflation coupled with accelerated exchange rate depreciation.

The objective of exchange rate manipulation is to secure a reasonable supply of foreign exchange to the official institutions. Government may be prepared to tolerate an unofficial market, but it will wish to command net foreign exchange sufficient to pay for fuel imports, interest charges and to cover imports of essential items. Attempts to ration foreign exchange do not work simply because there is no reason why the public should surrender foreign exchange to the officials at the official rate when they may do much better by selling on unofficial markets. Making such unofficial transactions illegal usually has very little effect since it is impossible, except in totally state-controlled societies, to police individual foreign currency transactions. Any feasible policy must therefore attempt to eliminate the excess demand for foreign exchange.

To eliminate excess demand for foreign exchange the authorities may reduce aggregate expenditures while leaving real income unchanged. Essentially, if they succeed they would have induced an increase in hoarding of domestic money. The only policy variable that might do the trick is an increase in interest rates on monetary instruments. A second alternative would be to switch aggregate expenditures from foreign goods and services to domestic goods and services, while leaving real income unchanged. Under some circumstances, exchange rate policies should have this effect, as should specific types of tax policies which are biased in favour of higher taxes on traded goods. Even if the policies are effective, however, expenditure switching will occur only to the extent that there is capacity for additional production of home goods to supply the demand which otherwise would have gone on imports. A third line of attack would be to accelerate the growth of exports, again perhaps by exchange rate measures, export subsidies or other support. This is an attractive tactic in theory but one which is extremely difficult to attain in practice. The fourth, most painful, but most common means of adjusting is by reducing real income, which in turn reduces the

ability to spend on imports. Contractionary fiscal policies and credit restrictions are among the measures which may have this effect.

The problem with all attempts to eliminate the excess demand for foreign exchange is that any weakening in the value of the domestic currency in terms of foreign currencies itself generates additional demand for foreign exchange in small countries. This issue has been debated in the theoretical literature on currency substitution. If the US dollar were legal tender in Barbados at the present time most Barbadians would elect to be paid their wages in US dollars; over time the bulk of transactions would be conducted in US dollars. The US dollar is not more commonly used principally because it is not legal tender in Barbados, and for most transactions one would have to incur the cost of a foreign exchange transaction in addition to the cost of payment. Moreover, the existence of exchange controls means that the transaction might be subjected to bureaucratic delays at best, and might be prohibited under some circumstances .

In spite of this, there is a small portion of trading in Barbados conducted in US dollars. It is inevitable in a country which is very open and where there is a large volume of foreign trade transactions relative to the national product. There is a substantial availability of foreign exchange and a considerable need for foreign exchange. Inevitably, for some proportion of these transactions it will be convenient to circumvent the official legal restrictions. There would be a far greater number of such transactions in foreign currency if people were to suspect that the value of the Barbados dollar were about to depreciate. In a small country where there were no legal restrictions on the use of foreign exchange an issue of domestic currency would be quite futile. If a local currency is introduced and is proclaimed as the sole legal tender, citizens would condescend to use it so long as for all practical purposes it is as good as the foreign currency. However, should they suspect that it is no longer as valuable as the equivalent foreign currency, they will take steps to substitute foreign currency.

If currency substitution takes firm root, authorities are extremely limited in their management of the exchange rate. They will not be able to sustain a system of foreign exchange rationing by means of exchange controls. The extent of circumvention will grow as the system devises new institutions to facilitate the unofficial exchange of foreign currency. It therefore behoves the authorities to move to a relatively simple exchange control system which covers only reasonably large transactions; they might just as well condone private trading in foreign exchange for small transactions. They must also take action to cut the demand for foreign exchange so as to reduce pressure on the supply of foreign exchange to official sources. Since foreign exchange is usually obtainable slightly cheaper

from the official agencies than on the black market, there is always a tendency to sell on the black market and buy from official sources. To alleviate these pressures, the official rate would have to be set fairly close to the black market rate. In addition, the overall demand for foreign exchange must be cut back until it begins to come within the reach of the available supply of foreign exchange for both markets. It is unlikely that the authorities will have much success in encouraging hoarding of domestic currency since the public confidence in the value of the domestic currency is being constantly eroded. If domestic costs and prices rise more slowly than the exchange rate depreciates, there may be some expenditure switching from imports to domestic goods. In highly open economies, however, this gain may be relatively modest. It has usually been necessary in the experience of small open economies to reduce real incomes in order to curtail the demand for foreign exchange.

A recommended strategy for a country like Jamaica facing a deficit in foreign exchange would involve:

1. Maintaining an exchange control regime geared to large transactions only. It might include the registration of exports and a requirement for the repatriation of the proceeds. Exporters should be encouraged to sell at the official rate. There should be no limitations of documented,

licensed imports and foreign exchange should be made available at the official rate to the extent that official stocks of foreign exchange will allow. There should also be no limitation on legitimate, documented non-trade payments which should also be serviced at the official exchange rate;

2. Import controls should be concentrated on a few strategic items which allow for monitoring without an elaborate administrative super-structure;

3. The official exchange rate must be set not too far away from the unofficial rate. It must also be revised as necessary to secure enough foreign exchange to meet the demand on the official market;

4. An increase in taxes on imports to encourage a switch away from imports;

5. A cut in government transfer payments and a freeze in the real wages of the civil service, so as to curtail aggregate expenditure;

6. A tightening of consumer credit.

The probable result of these measures is a continuously depreciating currency and an associated high rate of inflation,

but this is probably the least damaging course of action as far as the country's growth prospects are concerned. It avoids discouragement to investment, particularly foreign investment, and it does not create the shortages of raw materials and other essential inputs which will result from an attempt at foreign exchange rationing. Over time, exports from other business may, improve if domestic costs rise more slowly than the exchange rate.

The extent to which this will increase the supply of exports in small countries which produce a limited range of specialised products is still a matter of debate. If a greater volume of exports can be secured in the long run, the country may indeed b better off. It is not so evident that an increase in the demand for exports will be beneficial; this will happen only to the extent that the elasticities of demand for exports are sufficiently low that the falling price will secure much larger volumes of exports, and it depends still on the relaxation of th supply constraint.

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