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Discussion: Internal Effects of Devaluation

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The following remarks intend to follow up the suggestion of Professor Onitiri.

Frequently, the effects of changes in the exchange rates are discussed primarily in terms of the effects on imports and exports. Whether devaluation will or will not improve the balance of payments in terms of foreign exchange and/or in terms of domestic currencies is, of course, important. One argument against devaluation has been that it will not in fact increase the dollar value of exports, but will shift the terms of trade against the devaluing country, and that it is therefore undesirable for underdeveloped countries.

On the other hand, many advisors in underdeveloped countries stress the fact that the correct exchange rate is one of the few crucial prices in the economy within the control of most small countries[1] with a strategic influence on the structure and speed of development. The arguments in this context, while not neglecting the balance-of-payments effect, nevertheless stress the internal effects of an exchange rate adjustment.

These remarks emphasize the internal effects of devaluation. It is postul at the outset that devaluation will not by itself solve all other problems. As Pro Onitiri has suggested, to become effective, devaluation must be accompanied by othe policies which may or may not be feasible in terms of the internal structure of the countries or in terms of political realities. In the last analysis, only the citizens of a country will as a rule be able to judge potential feasibilities. An outsider must however stress that real problems implied by an overvalued exchange rate are not solved but at best postponed by claiming that politics makes their solution not feasible. A country must be very lucky if developments in the rest of

the world make its own action unnecessary!

1. It is claimed that devaluation is useless for the balance-of-payments adjustments in the case of raw material exporting and industrial goods importing countries. Most black African countries south of the Sahara fall into this category. In their case, the price of e.g. cocoa or groundnuts, is determined on the world market. It is then translated into domestic currencies at whatever rate of exchange is fixed. The only control a country has over its foreign exchange receipts rests with the supplies of cocoa and grundnuts which depend in turn on the producer prices. The terms of trade at the border and in terms of foreign currencies are in this case assumed to be unaffected by the actions of any single country.

The producer price in terms of domestic currencies depends on export taxes, (e.g. in the form of Marketing Board "profits", or possibly export subsidies), as well as on the exchange rate. The domestic interest is, therefore, first whether export production can be increased by allowing higher domestic prices; secondly, what the budgetary effects are of the combination of higher producer prices and a devalued exchange; and thirdly what other domestic effects might result.

Suppose for the moment that export receipts in terms of foreign exchange are independent of the actions of the country contemplating devaluation. Since imports depend on the export earnings which are supposed not to be affected by devaluation, it follows that its import possibilities are also independent of it. Expressed in foreign currencies, the terms of trade do not change. The point, that imports become more expensive, in terms of domestic currencies is therefore in the first instance irrelevant!

The level of domestic investments, and in general the rate of development, depend on getting sufficient complementary imports. <u>The fact that imports become more expensive in terms of domestic currencies is a desirable effect of the devaluation</u> since it improves the allocation of the (constant) volume of imports. This means that

unless absolute fixed proportions of imported-to-domestic factors are supposed-- a dubious assumption-- total investments will rise, as the available imports are more economically used. More precisely, for a given amount of imports more domestic factors are used when imports are more economically allocated. In this sense the improved allocation allows a potentially larger amount of investment, other things being equal. Of course, whether or not the investment volume should or will be larger depends on such "other things" as social profitability, subsidies, and the like. It is clearly desirable to allocate the available imports so as to maximize growth.

As a theoretical proposition it must be recognized that there may be a conflict between growth and efficiency, and that a better allocation of the existing imports will not necessarily lead to increased growth. As a matter of real situations, I know of no case in which the conflict between growth and efficiency, or for that matter the theoretically equally possible conflict between efficiency and equity, exists. Theoretically, moreover, it is clear that such a conflict exists only when we have reached some kind of optimum. The real situation requiring devaluation is so far removed from such an optimum that improved efficiency will lead to more growth <u>and</u> more equity. Recognition of a theoretical conflict is consistent with belittling its factual importance.

It is also frequently desired that there should be <u>economic</u> import substitution. Raising the domestic price of imports will induce that import substitution, will lead to a more effective use of foreign exchange both by substitution (within technically feasible limits) of domestic for foreign resources in particular projects and by shifting the project mix in the direction of projects using relatively much domestic resources. The given level of imports could certainly maintain a higher level of gross investments and/or consumption. Whether more or less should go into investments or consumption depends also on sufficient economically viable and/or socially desirable projects being available in the economy, whether in the government or

private sectors.

It is also a policy objective to industrialize. While at present all African countries south of the Sahara fit the description of primary product producer several of them, among them, Nigeria, the Ivory Coast, Cameroon, and Kenya, have begun to develop industries and have a reasonable chance to expand their industrialization. Overvalued exchange rates tend to produce a bias against exports in general[2] and produce a type of growth of industries that can be shown to be statistical rather than real in nature and to represent largely a transfer of resources from agriculture and other sectors to industry.[3,4] This in turn means that such industrialization cannot continue for long and bears the seed of its own destruction instead of the possibilities of continuous growth.

2. It is claimed that the equilibrium exchange rate cannot be defined independently of the level of protection, and that in any case tariffs are an alternative to devaluation which have the additional advantages of producing government revenue.

This argument is only partially correct. Tariffs will hinder imports as will devaluation. In order to get a true alternative to devaluation, we would have to combine import duties and export subsidies. Rebates of import duties alone for exports will not do the job. It will not affect all new or potential industries that use imported materials as inputs, and must substitute protected goods.

(a) Import duties should be used either for fiscal reasons because they are the easiest and perhaps also the socially most acceptable[5] way to collect taxes. This would be particularly proper for luxury goods such as whiskey. In this case the import duties should be supplemented by an equivalent domestic tax to prevent a distortion of the productive structure in favor of goods consumed by the rich. This is not said for any moral reasons but because taxing luxury imports at the border but not internally would stimulate their domestic production, which in turn would shift the spending pattern of the rich from savings and investments into consumption: such a policy would stimulate savings by the rich. The policy of

using customs duties for fiscal reasons works only to the extent to which import substitution of luxury consumer foods is prevented by matching excise taxes.[6]

(b) Or else, import duties should be used as a protective device if, and only if, they are the best method available to achieve this aim. Normally, devaluation and some imports to maintain standards and some technical assistance in manufacturing and marketing and some subsidies linked to performance are clearly preferable-- and cheaper to the economy. Import duties are discriminatory in a way that devaluation is not, even if accompanied by export subsidies. They should be used for specific purposes, and not as an alternative to devaluation.

3. Devaluation will allow a simplification of the tariff and tax structure and will help solve budgetary problems. All underdeveloped countries expect their government to produce a substantial amount of savings, i.e. to produce surpluses in the current budgets and public enterprises. All countries have the greatest difficulty in achieving this aim. Where there are Marketing Boards, as in Nigeria, devaluation will allow raising producers' prices in domestic currencies while at the same time raising budgetary resources.

The important and desirable effect of devaluation lies here in (a) shifting the internal terms of trade in favor of agriculture and against urban consumers, and generally in favor of domestic producers against importers, and (b) in increasing domestic surplusses that can be used for investment. In other words, ex-farm prices would rise relative to wages and salaries, and the prices of import substitutes would rise relative to other products. As indicated above under (1), it is so far assumed that at worst, the volume of total imports will not change as the result of devaluation. In part, the improved internal allocation of imports will increase export earnings and hence also imports for all purposes. In this case, devaluation will not only lead to better allocation of imports; but will stimulate savings and investments, economic expansion and proper (because economic and hence self-sustaining) import substitution.

(to that extent the domestic price bears no direct relation to the foreign price.)

4. The shifting of the internal terms of trade in favor of agriculture is also important if the employment problem is, if not to be solved, at least, to become manageable. The employment problem has of course many roots: rapid population increases; a rapid movement to the urban centers; a distorted wage structure in favor of urban wage earners, and many more, including powerful non-economic ones. For that reason there cannot be a simple answer to the problem. Devaluation allows the raising of rural earnings relative to those of the cities. It allows also increased payments by urban dwellers for the social services they require. Both are essential if the urban problem is to become manageable.

5. Certain political difficulties must be faced. Devaluation ~~will~~ raise prices of imported and exported goods in terms of domestic currencies. This is, from an economic standpoint, their desirable effect. There will, therefore, arise pressures to raise urban wages and salaries. The political questions relate to the extent to which the government can pursue a policy of raising farm producer prices without compensating increases in urban wages. As long as there is import licensing, imports will be ~~allocated to investments~~ limited administratively anyway; it should in this case be feasible to resist the raising of urban wages by allowing also some cheap imports of items of mass consumption. With the-- economically highly desirable-- substitution of market for administrative allocation, a judicious policy of low import tariffs for items of mass consumption would help. But some politically difficult holding of the line with respect to urban wages and salaries is inevitable.

It should, however, not be imagined that an overvalued exchange rate will do more than temporarily avoid the political problem. There will be heavier taxation of farmers, which also will lead to political resistance sooner or later-- and, as the examples of Ghana and Nigeria show, sooner rather than later. Nascent industrial enterprises will inevitably misuse the available foreign exchange,--what

happens in reality depends on the actual cost with which they are faced, not on plans-- hence lead to less growth and employment than desirable. The relatively heavy agricultural taxation and relatively high urban wages will increase the flow of labor to the urban centers requiring more expenditures while at the same time, taxable capacity will grow inadequately because of inefficient investments. If farm prices are allowed to rise, the resulting shortfall in tax receipts will be made up, where possible, by inflationary finance. Of course, discovery of large amounts of petroleum, as in Nigeria, will cover a multitude of sins. Nevertheless, even in this case it is desirable to bring inflation under control, to stem the flow of labor to urban centers as well as the generally self-defeating wage awards. The focus of political problems shifts but is not eliminated by a refusal to devalue. Sooner or later the issue has to be faced if growth is to become efficient and pressing social problems to be solved.

If, as is the case in francophone West African countries with a common Central Bank, inflationary financing is practically impossible, it remains true that an overvalued exchange will prevent an efficient nascent industrialization and will in general lead to a relatively tight budgetary situation.

6. To sum up: Even if devaluing an overvalued exchange rate will leave the value of exports of primary products in terms of foreign exchange unchanged, the constant volume of imports must be allocated more efficiently. Devaluation has the advantage over a system of import duties and export subsidies in being less discriminatory and hence more efficient. In any case, import duties are not as a rule accompanied by the necessary export subsidies required to make the system logically acceptable. To be effective, devaluation requires policies of wage restraints in the urban sector, and policies in the nascent industrial sector which stress the efficient allocation of resources and which ruthlessly refuse

direct or indirect budgetary subsidies that essentially transfer income from efficient to inefficient production. The economically desirable effects of devaluation are the improvement in the internal terms of trade of rural vis-à-vis urban dwellers and the increase in the domestic cost of foreign exchange.

The argument for devaluation is made in terms of efficiency. It is realized that there are other aims besides maximum output and/or maximum growth, such as better regional or personal income distribution. It is however, argued that in any real situation we are so far removed from an optimum that would require this kind of hard choice that in fact equity and growth are compatible and would both be improved by a more efficient allocation of resources.

Devaluation will nevertheless lead to political problems, but they are not the kind that can be defended on the grounds of equity, but only on the grounds of power. Urban dwellers are already likely to be better off than rural dwellers. Devaluation would rectify that imbalance, while continued misallocation of resources is likely to lead sooner or later to political problems in the rural sectors. The political problems are not solved by refusing to face them.

Devaluation is essential if a beginning with efficient import substitution and industrialization, increased growth, and a solution of the problem of urban migration and of other social problems is to be made.

[1] When several countries belong to a common monetary union, as is the case with several francophone African countries, or may be the case in the future in the European Common Market, the control over the exchange rate shifts to the group as a whole. In addition, no country can change its currency vis-à-vis others if others counteract it, as was the case with competitive devaluations during the 'thirties.

[2] See Ian Little, Tibor Scitovsky, and Maurice Scott, Industry and Trade in Some Developing Countries, OECD, 1970, pp. 66 ff. Also the various country studies by five authors.

[3] See Little, Scitovsky and Scott, op. cit., pp. 75, 73:

For example between 1950-2 and 1964-6, GDP in Pakistan as conventionally measured grew at 3.8% p.a. Where allowance is made for the distortion of the price structure due to protective policies the growth rate is diminished to 3.2% p.a. (Table 2.13 p. 75) The annual growth rate of agriculture is 1.2% and 1.3% respective that of industry 0.6% and nothing respectively! In other words, the whole of the "growth" of industry is really a transfer from agriculture (and other sectors). As a percentage of GDP, industry in 1963-4 in Pakistan accounted for an un-negligible 7%. When allowance for protection is made, it is a negligible 0.4%!

[4] Studies comparable to the OECD studies directed by Ian Little do not exist for other countries. For Nigeria, there is some evidence that import substitution has in some individual cases been inefficient. Peter Kilby, Industrialization in an Open Economy: Nigeria 1945-1966, Cambridge University Press, 1969, points out that: "All evidence suggests that the foreign exchange cost of domestically produced cloth is greater than that of imported cloth.., In the most unfavorable and increasingly important case of printing an imported cloth, the cost of the

imported raw materials alone exceeds the value of the imports being replaced!" (op. cit. p. 126). There is a loss of foreign exchange in diminished cotton exports, which moreover are sold "to northern textile production at a price 10% under the export value." (op. cit. p. 125). Since textiles account for a substantial part of industrial production and its growth in the Nigerian GDP., it seems clear that the official figures calculated in market prices overstate that growth and also hide a transfer of income from agriculture to industry-- the price for cotton being 10% below world market prices making the point (in part) in a most obvious manner.

Industries are yet small in Nigeria. It would be a pity if industrialization and growth in this country were jeopardized by first building up inefficient industries by overvalued exchange rates and excessive protection.

5 If most imports for consumption are goods demanded by upper income groups, tariffs would be a partial substitute for a progressive income tax.

6 This is an argument that has been made, e.g. in Pakistan. It would lead too far to list all other conditions that must be met. Suffice it to list one important one: the government itself must not be the biggest dissaver of them all. Otherwise, a smaller amount of taxes collected would be more desirable all around.

in Africa and Monetary Institutions, ed by Rodrigue Tremblay
Holt, Rinehart, and Wilson, Montreal, 1973, p. 411-419)