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Exchange Rate Equilibrium and
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One of the main objectives of economic integration is to increase the competitive strength of the productive process. This generally requires significant adjustments to take advantage of the new opportunities offered by a larger market and to overcome the handicaps resulting from inefficient operation and other factors. But, these adjustments may produce serious strains and stresses for the economies of some of the participating countries, or at least for some important sectors of those economies.

As the barriers to intra-regional trade come down, some enterprises are likely to find themselves at a disadvantage in competition with their rivals in other participating countries, either because their costs of production are higher or because they encounter greater difficulties in expanding their facilities to serve the enlarged market. This disadvantage may apply only to some of the firms in a given participating country or it may be generalized, affecting a major part of national production.

1/ This paper was prepared for the Meeting of Central Bank Technicians of the American Continent, Buenos Aires, November 1966.

If the general level of production costs is higher in one (or more) of the participating countries, or if investment in one (or more) of the countries is generally subject to greater difficulties than in the others, the process of integration is likely to cause balance of payments disturbances and to require basic readjustments, including changes in one or more areas of public policy.

In a common market, the adoption of a common external tariff poses further problems. Where this entails an increase in tariffs, some relief from foreign competition may result, but domestic prices may rise. Where tariffs are lowered, domestic prices may fall, but domestic enterprises must now face intensified external competition. In either case, the yield of import duties may change, the direction of the change depending on the elasticity of demand for the products affected, and this may produce fiscal and/or monetary repercussions. If the tariff changes are large and widespread, the resulting disequilibrium may be of a structural nature.

The prospect of these strains and stresses has led the countries taking part in economic integration movements in Europe as well as in Latin America to seek ways of minimizing the adjustments involved, or at least of easing the transition. They have allowed themselves ample time to complete the process and provided themselves escape clauses. They have exempted certain economic sectors (e.g., agriculture), or limited the process to agreed fields of activity, or circumscribed it by avoiding automatic reductions in barriers to intra-regional trade and instead conducting periodic negotiations. In the case of the Latin American Free Trade Association, they have discussed the merits of achieving an equivalence of additional trade flows among themselves and, when this could not be agreed upon, they have provided a procedure to deal with cases in which a participating country suffers "pronounced and persistent disadvantages" in trade with the other participating countries as a result of the mutual tariff concessions. 1/

However, the readjustments made necessary by the integration process must be carried out it the common market (or the free trade area) is to become a functioning reality. It is not a matter of minimizing them, but rather of deciding how (and how fast) they shall be allowed to take place. If only a few domestic enterprises find themselves at a competitive

1/ Treaty of Montevideo, Article 11.

disadvantage, these enterprises will have to find their own ways to cut costs and to survive. But the authorities cannot ignore situations which are sufficiently generalized to affect a major part of national production or which have an impact on the national economic outlook, especially one of a structural nature. The policy alternatives in such cases are the concern of this paper.

I. Differences between the general levels of costs.

If the general level of production costs in one (or more) of the participating countries is higher than in the others, this may reflect the fact that the general level of wages (including fringe benefits) is higher. Or, it may be that the methods of production in use in all or most lines of activity are less efficient. Or, perhaps, there are greater difficulties in obtaining needed materials and supplies, due either to greater distances from the sources of supply, or to more formidable obstacles in reaching them.

Confronted by these differences, the authorities may wait for the adjustments to take place spontaneously. What is needed is an increase in productive efficiency so as to eliminate any existing backwardness in productive methods or to offset the handicap of higher wage costs and more expensive access to needed spontaneously, the authorities may step in and stimulate the adoption of more efficient methods of production by means of appropriate tax and other incentives. In particular, they may undertake to facilitate the transfer of resources from uneconomic activities to those in which the country has a comparative advantage within the common market (or free trade area) by such methods as training labor for employment in the new fields of activity, providing help in resettling workers (and their families) near the sites of these activities, offering incentives for investing in these activities (such as long-term, low-interest loans, special tax deductions for new investments, and accelerated depreciation allowances), rewarding through tax and other inducements the owners of plant, machinery, and equipment currently used in uneconomic activities who agree to terminate operations, and making available special unemployment benefits to workers who lose their jobs because of the closing of an uneconomic enterprise. They may even promote cuts in wage rates or fringe benefits (not usually a feasible alternative) or at least freeze the wage level until the wage levels in other participating countries rise sufficiently to eliminate the difference.

Reliance on an increase in productive efficiency in the export-oriented and import-competing sectors is desirable if the economy is to receive the full benefits of economic integration.

But, if the country's businessmen are slow to take advantage of the incentives to modernize and to invest in new activities, the balance of payments may be affected. Where the balance of payments was previously in surplus, the effect may be merely a reduced surplus (or its disappearance). This would be a tolerable development, and might even be welcome as an anti-inflationary turn of events. But if a balance of payments deficit should emerge (or a previously existing one be intensified), the situation would be different. Countries with sufficient reserves of foreign exchange or with access to adequate new credits abroad may be able to wait until the adjustment is achieved, but those with inadequate levels of reserves or unable to secure enough new credits abroad may find the adjustment process too slow. Before the adjustment can be completed, such countries may be compelled to take steps to protect their balance of payments. If these steps involve an intensification of fiscal and monetary restraints, 1/ the burden of adjustment, originally concentrated on the export-oriented and import-competing sectors of the economy,

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1/ The use of exchange and import restrictions would reverse the liberalization of trade among participating countries, unless they were directed only at non-participating countries. In a common market, the use of such restrictions against non-participating countries would be circumscribed by the need to comply with the obligation to adopt common external barriers to trade.

will spread to the rest of the economy, slowing down its growth, at least temporarily, both in contrast to the past and in contrast to the other participating countries. Quite aside from this, the social and political impact of a policy relying on an increase in productive efficiency to take place may be intolerable, especially if it involves a wage freeze, or wage cuts, or the displacement of surplus workers.

If the needed increase in productive efficiency in the export-oriented and import-competing sectors is not forthcoming reasonably soon, and either a protracted balance of payments deficit emerges, or excessively painful social and political changes are involved, this may indicate that the readjustments are so basic as to call into question the viability of the exchange rate. With an appropriate currency devaluation, the wage level which seemed too high may be made comparable to those of other participating countries and the inefficient production methods may be offset by lower wage costs. Moreover, the money cost of transporting the needed domestic supplies and materials to the point of production may be made more nearly equal (in terms of the currencies of the other participating countries) to the cost which the latter are incurring. 1/

1/ Little can be done by means of exchange rate adjustment if the materials and supplies are imported: it would take a currency appreciation to cheapen their cost in terms of national currency, but the new exchange rate would worsen the competitive position of the local enterprises in selling their products.

However, these results may soon be offset by the secondary repercussions of devaluation on costs and prices, unless suitable policies can be adopted to prevent such an offset from occuring. A devaluation would tend to shift the burden of adjustment from the export-oriented sectors and from those producing import-competing goods to those dependent on imports for a part of their supplies, and to those having to make invisible payments abroad for such things as shipping, insurance, interest and profit remittances, and foreign travel. These sectors would face increased costs in terms of national currency and might react by raising selling prices. If they account for a large part of national production, the rise in their prices may trigger wage demands which could offset any advantage temporarily gained from devaluation by the export-oriented and import-competing sectors. Moreover, if the export-oriented sectors are dependent on imports for part of their supplies, a devaluation may hurt them, perhaps more than it helps. Fiscal and monetary restraint as well as an "incomes policy" involving considerable wage discipline would be required to minimize these repercussions and make a devaluation effective. Even in this event, the prospect of devaluation would be unsettling, in that it would probably trigger an undesired outflow of capital, and should devaluation occur, it would represent a setback in the effort to promote financial coordination among the participating countries as a part of the integration movement, especially if it occurred near the end of the period of transition toward full integration.

Devaluation would also tend to boost the national currency earnings of the export sector, including enterprises exporting to non-participating countries. For many, this would represent a windfall which might lead them to cut the foreign prices of their products. To the extent to which lower foreign currency prices for exports meant lower foreign exchange earnings, [1] the result would be harmful to the country. To prevent this (where it seemed likely to occur) and to absorb any undue windfall profits, it would be necessary to raise the taxes (in terms of national currency) paid by such enterprises. Of course, if their tax liability is normally calculated in terms of foreign currency, the devaluation would automatically raise the yield of such taxes in national currency, and a change in tax rates may not be needed.

It would be difficult to calculate the extent of devaluation that might be called for. Only enough of a devaluation to permit the national enterprises to compete in the connom market (or free trade area) would be necessary, and not more than

1/ Whether it did or not would depend on the elasticity of demand for the exports affected.

would overcome the irreducible cost differences between national firms and their rivals in other participating countries, so that national firms would not be relieved of the obligation to make the cost adjustments of which they were capable. This would very likely be a very small devaluation if the bulk of the country's trade was with non-participating countries, and if the general level of costs in other participating countries, though lower than in the devaluing country, was markedly higher than in non-participating countries. A greater devaluation would not be needed for international payments equilibrium on a world wide basis, and would only produce an undervalued currency if it were to take place. The danger of miscalculating the exact amount of devaluation needed would be great.

Generally speaking, therefore, devaluation may involve more problems than it would solve. For this reason, it may be suitable in very few cases, if any, and only as a means of last resort, when the strains and stresses associated with the adjustments required in its absence to make the common market (or free trade area) a functioning reality are genuinely unbearable for the economy (or the political or social fabric) of the nation.

Some of the problems associated with devaluation could be avoided if the participating countries whose costs of production are generally lower than the rest would <u>appreciate</u> their own currencies. This might be a possible alternative, if these countries are in a minority. But new problems would arise in this case, since a currency appreciation would tend to put the industries of such countries at a disadvantage in selling in non-participating countries and in competing with imports from non-participating countries. Moreover, some of the problems of devaluation would remain, including that of determining the exact amount of appreciation needed, that of dealing with the possibility of unsettling capital movements, and that of reconciling appreciation with progress toward financial coordination among the participating countries.

A special case may arise if the country whose costs of production are higher in most industries is one which enjoys such an enormous comparative advantage in international trade in the production of only one (or a very few) products that the equilibrium exchange value of the currency is far too high to allow other lines of activity to be competitive on the world market. In such a case, the cost of producing other products appears high largely because of the level of the exchange rate and it would seem that a devaluation (accompanied by a corresponding cut in tariffs) would correct this condition, provided the secondary repercussions on costs and prices can be held down.

This case has been discussed in detail as it applies to Venezuela by the distinguished Venezuelan economist, Dr. Ernesto Peltzer, 1/ who believes that, in Venezuela, it would be impossible to prevent the secondary repercussions from wiping out the primary effects of devaluation and that in the end the domestic costs of production would be about as much above those of other countries as before the devaluation. In his 1944 article, Dr. Peltzer suggests that, to minimize the effect of the overwhelming role played by the petroleum industry, Venezuela should try to limit the activity of the petroleum industry as such rather than manipulate the exchange rate. In the more recent article, he recommends a system of export bonuses for products other than petroleum and iron ore (in effect a partial devaluation on the export side), and an adjustment of the intra-regional tariff cutting process called for by the creation of the Latin American Free Trade Area whereby the Venezuelan tariff cuts would be reduced by an amount equal to a "coefficient of overvaluation."

1/ See E. Peltzer, "La Industrializacíon de Venezuela y el Alto Tipo de Cambio del Bolívar," Revista de Hacienda, Vol. IX, No. 17, (Caracas, December 1944), and "La 'Sobrevaluacíon' del Bolívar y la Integracíon Económica Latinoamericana, Revista de Economía Latinoamericana, Vol. 4, No. 15, (Caracas, 1964), reprinted in his "Ensayos Sobre Economía," (Banco Central de Venezuela, Colección XXV Aniversario, Caracas, 1965), pp. 147-174, and pp. 441-457.

However, there is the danger that a limitation of the activity of the petroleum industry would produce serious problems of another order which would prove even more unsettling to the economy. Also, it is difficult to see how an adjustment to the tariff cuts, which in effect would prevent intra-regional trade barriers from being completely abolished, would be consistent with full membership in the Latin American Free Trade Area. In view of the serious drawbacks which a devaluation may involve, it would seem that the preferred solution would be to promote actively the necessary adjustments in the export-oriented and import-competing sectors, along the lines of the suggestions made at the beginning of this section, without changing the exchange system. The fact that the general level of wages in Venezuela is relatively high may give the country a comparative advantage in capital intensive industries within the Latin American Free Trade Area. A serious attempt to exploit this advantage at existing exchange rates should be made before admitting that Venezuela faces a special problem which requires other solutions. Although the two cases are probably not fully comparable, it should be noted that the great importance of petroleum to the economy of Texas has not prevented the growth of other industries there, or created unemployment in that State, or required an adjustment in the exchange rate between Texas and the rest of the United States.

II. Differences in investment climate

The competitive disadvantage experienced by one (or more) of the participating countries may be due to the fact that the investment climate there is less attractive than in the other participating countries. This may be because of political uncertainties (such as fears of expropriation), or because of currency instability associated with inflation, or because the laws under which business must operate are not as favorable from the standpoint of taxation, labor relations, degree of government intervention, corporate organization, capital markets, etc. In all of these cases, domestic businessmen may be reluctant, or unable, to expand their facilities to serve the enlarged market, and foreign businessmen may prefer to locate elsewhere.

The most logical corrective action in this situation is to eliminate the cause of the difficulty. This would involve improving the political atmosphere, ending inflation, and carrying out legal and institutional reforms in such fields as taxation, labor relations, and business organization and financing. However, these objectives may be more easily described than reached, especially when it comes to overcoming political uncertainties. Unfortunately, there is no ready alternative. In particular, an exchange rate adjustment per se would do little or nothing to increase political stability or improve attitudes toward investment in such a country by domestic and foreign businessmen.

Is it true that, under inflation, exchange depreciation would help to preserve (or to restore) the incentive to export (and to deter imports) and as such would improve the attractiveness of investment in export-oriented (and import-competing) activities. But this would more appropriately be called an offset to the high cost of production brought about by inflation than to the fears of currency instability themselves. As regards the latter, exchange depreciation, unless accompanied by a comprehensive program of action to stop inflation, would merely serve to confirm the worst fears of businessmen and to strengthen their belief that the investment climate was indeed unattractive.

III. Adoption of a common external tariff

While differences between the general levels of costs and differences in investment climate among participating countries may occur either in a free trade area or in a common market, the creation of a common market provides an additional complication because it involves the adoption of a common tariff against the outside world.

Where the adoption of a common external tariff entails a rise in tariffs on the major part of a participating country's imports, the upward pressure on domestic prices may be serious. A rise in prices of articles used in domestic production has the effect of worsening the competitive position of domestic enterprises compared to their rivals in other participating countries, unless they can cut costs in other ways. In general a participating country required to raise tariffs on the major part of its imports would be likely to be one with a general level of production costs below that of the other participating countries. This would tend to result from the fact that its relatively low level of tariffs had exposed it to more competition from abroad than would be the case for the other participating countries. Hence, such a country should be in a favorable position to withstand some worsening of its competitive position compared to the other participating countries. But, if the tariff increases (in conjunction with parallel cuts in the external tariff of other participating countries) more than offset any pre-existing cost advantages, the effect may be serious.

If the effect is widespread, as is likely to be the case especially if imported articles represent an important fraction of total supplies for the economy, the situation may be one of structural disequilibrium, as in the case discussed in the first section of this paper. If the cost reductions needed to offset the higher tariffs cannot be carried out successfully in the prevailing social and political enviornment, it may be that, as an alternative, a currency appreciation may be adviseable as a means of cheapening the cost of imports. Even if the articles whose prices are increased by the tariff adjustment are mainly consumer goods, there may be a case for appreciating the currency as an anti-inflationary move.

A currency appreciation would tend to shift part of the burden of adjustment to the higher tariffs from the sectors of the economy dependent on imports to those oriented towards exporting or towards the production of import-competing goods. This means that there are limits to the use of exchange appreciation in this case, for the authorities must be careful that the exchange rate does not penalize exports and/or stimulate imports to an extent that would threaten the equilibrium of the overall balance of payments. However, there is likely to be some room to maneuver, since the rise in import duties must bring about a cut in imports and since the proposed currency appreciation would presumably result in only a partial offset of this cut.

Where the adoption of a common external tariff entails a decline in tariffs for the major part of a participating country's imports, two types of repercussions may ensue. To the extent to which the lower tariffs affect articles used in domestic production, there will be an improvement in the competitive position of domestic enterprises compared to their rivals in other participating countries. At the same time, to the extent to which the lower tariffs affect articles which compete with domestically produced goods, the resulting intensification of external competition may seriously prejudice domestic enterprises.

If the first type of repercussion predominates, the net effect on the economy is likely to be beneficial. Firms facing stiffer competition from non-participating countries (or from within the common market as intra-regional barriers to trade are lowered) will be better able to meet it as their costs are brought down by the cut in tariffs on articles they use in production. 1/ But if the second type of repercussion predominates, the net effect may be injurious to the sectors of the economy involved. If these account for a major share of national production, the effect may be as if the general level of production costs had become relatively higher than those abroad.

If it proves to be difficult for the affected enterprises to cut production costs in order to hold their own, there may be no other way to correct the structural maladjustment which is involved than for the authorities to devalue the currency to an appropriate extent to prevent excessive imports and bring about some increase in exports with which to pay for the enlarged imports. In general

1/ This would further weaken any argument for a devaluation by such a country to deal with a level of production costs generally above that of other participating countries.

a participating country called upon to lower its tariffs on the major part of its imports would be likely to be one whose level of production costs was generally higher than that of other participating countries. This would tend to result from the fact that, because of the relatively high level of its tariffs, it had been sheltered from competition from abroad more than they were. Hence, such a country would be hurt both by the lowering of intra-regional trade barriers and by the lowering of its external tariff as part of the adoption of a common tariff against non-participating countries.

While the case for a devaluation by such a country would be strengthened if a pre-existing cost disadvantage reinforced the effect of the cut in external tariffs, this would not necessarily overcome the other difficulties associated with devaluation already discussed. Because of these difficulties, discussed in the first section of this paper, depreciation should be considered only if a major portion of domestic production is threatened by the cut in tariffs and other ways of cutting production costs appear quite unpromosing. In any event, the currency should not be depreciated to such an extent as to trigger a rise in domestic prices which would wipe out the cost benefits accruing from lower external tariffs.

Whether the adoption of a common external tariff entails a rise or a fall in most tariffs, the yield of import duties will probably be affected, and the impact may be large enough to trigger fiscal and/or monetary repercussions. The elasticity of demand for imports will determine whether the yield of import duties rises or falls as the level of most tariffs rises or falls. If the yield rises, the Government may have the choice of cutting other taxes correspondingly or of using the larger revenues to increase expenditures or of reducing its deficit (or running a surplus). These are alternatives which would generally benefit a country 1/ and nothing more needs be said about them.

On the other hand, if the yield of import duties falls, the available choices are all painful: either a cut in expenditures, or a rise in other taxes, or an increase in the government deficit (or a reduction in its surplus), or a combination of these. The first two alternatives spell austerity, while the third may spell inflation unless its effect can be offset by appropriate measures of monetary restraint which in

1/ If the authorities chose to increase expenditures, the possibility would exist that, even though the budget deficit (or surplus) remained unchanged, the multiplier effect of these higher expenditures would disturb the equilbrium of incomes and prices in the economy. This would happen if the propensity to consume of the recipients of these increases in expenditures were different from that of the sectors paying increased tariffs.

turn spell austerity in the private sector. If the austerity involved (or its alternative, inflation) is moderate, it may be socially and politically tolerable. But if the cut in the yield of import duties is large, and if these duties account for a large fraction of total government revenues, the austerity (or the alternative, inflation) may be severe.

In such a case, an appropriate exchange adjustment designed to redress the budgetary situation may obviate the need to take unpalatable austerity measures. Whether this must be a currency appreciation or a devaluation would depend on the elasticity of demand for imports since the objective is to reduce the extent of the decline in the yield of import duties. The scope of a currency appreciation is, of course, limited since, as before, it must not be so large as to damage exports (or encourage imports) to the point where overall balance of payments equilibrium would be destroyed. All of the other difficulties associated with a devaluation or a currency appreciation, which were discussed in the first section of the paper, would apply in this case and need not be repeated.

However, it should be noted that, if the country experiencing a decline in the yield of its import duties also has a level of production costs generally above that of the other participating countries, the use of exchange adjustments may be ruled out. If the decline in the yield of import duties occurs under conditions where a currency appreciation might restore the budgetary situation, such an appreciation would be the exact opposite of what might be indicated to ease the adjustment of the high costs of production. Only if the decline in the yield of import duties occurs under circumstances in which a devaluation might restore the budgetary situation, would this coincide with the solution which, theoretically at least, might be suitable to deal with the differences in levels of production costs. While this would somewhat strengthen the case for devaluation, it would not per se overcome the principal difficulties associated with devaluation already discussed.

IV. Conclusion

The argument of this paper is that the adjustments made necessary by the creation of a common market (or free trade area) may be such as to call into question the equilibrium of the exchange rate. If so, the problem arises whether a suitable currency depreciation or appreciation, as may be appropriate, may be a desirable way of dealing with the structural disequilibrium which is involved. The analysis of this paper suggests that the best course of action remains to carry out the "real" adjustments that integration requires at existing exchange rates. Only when this turns out to be genuinely impossible should exchange adjustments be made. Specifically, they are acceptable only when the strains and stresses which would otherwise be incurred to make the common market or the free trade area a functioning reality are more than the economy (or the political of social fabric of the nation) can stand, and always on the condition that the repercussions from currency adjustment will not wipe out the benefits derived from it or create other perhaps more serious problems. An important consideration supporting this conclusion is that in some cases, the exchange adjustments appropriate to deal with certain aspects of the problem are the exact opposite of those appropriate to deal with other aspects of it.

In general, exchange stability (and policies naturally conducive to it) is to be preferred. Not only does it form an essential part of a healthy investment climate in which businessmen will find it easier to carry out adjustments required to operate in an enlarged market, but in addition, it will facilitate the establishment of financial relationships among the participating countries and their banks, which are essential to extend the integration process beyond the commercial field. Indeed, if the participating countries suffer from currency instability, as a number of South American countries do, it may be difficult to go much beyond the commercial stage of economic integration.

It is true that exchange stability does not mean exchange rigidity and that there is room for exchange adjustments in the arsenal of economic weapons to cope with structural disequilibrium (where it exists), as the Bretton Woods Agreement recognized. But for practical reasons, as well as to give the needed increases in productive efficiency a chance to occur, it would be desirable, if this weapon is used at all to facilitate a movement toward integration, that it be used infrequently, perhaps only once in the course of the transition period during which the common market (or free trade area) is being created, preferably at or near the start of the transition period.