Balance of Payments Problems of Developing Countries, Part II

In an article in the June 1967 issue of Finance and Development, *Poul Høst-Madsen discussed some balance of payments problems that are special to developing countries; in this final article he discusses how these difficulties can be overcome.*

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IN PRINCIPLE, the methods available to the developing countries for correcting deficits in their balance of payments are the same as those available to other countries. However, as we have seen, the problems of developing countries present special features, and so some of the remedies they have used to solve them are also special. Some possible (or apparently possible) remedies are in accord with the philosophy underlying the establishment of the International Monetary Fund, but others are not, and it is two of the latter that I should like to discuss first.

Import and Exchange Controls

A majority of the developing countries apply import as well as exchange controls, and experience shows that these controls are difficult to dismantle. In fact, such controls are so common that it seems unrealistic to consider their introduction in deficit situations as a possible method of adjustment; since they have normally been introduced already, increased reliance on them is a more common course of action.

Permanent reliance on a rigid system of exchange and import restrictions may have harmful effects. If they are used in the face of excess demand they easily lead to scarcities, bottlenecks, and other distortions in the economy. They stimulate production for which the country applying them may not be naturally geared and hence may lead to a misallocation of resources. Often they are used in an inflationary situation to protect an overvalued currency. In such circumstances the issuance of an exchange or import permit becomes a privilege of considerable economic value, and is often conferred on the basis of the imports of individual firms in some past year or on similar criteria. The high profits with which the receipt of a permit is associated may stimulate bribery and corruption, and the historical basis adopted in the administration of the restrictions makes it difficult for new firms to become established and grow. For all these reasons, the usefulness of exchange restrictions as a method of balance of payments adjustment is questionable. Where there is considerable excess demand, import and exchange restrictions can assist, of course, in reserving scarce resources of foreign exchange for imports considered to have a high priority from the standpoint of development. It is preferable, however, as far as possible, to use measures of fiscal and monetary policy to adjust total import demand to the limitations of the available resources and to regulate demand for consumption and investment goods in accordance with the targets set for each. Restrictions cannot be relied upon to maintain a high level of capital formation in the face of excess demand; it is also necessary to secure the amount of saving and foreign financial resources to finance the investment.

Multiple Exchange Rates

Use of a system of multiple exchange rates is another method of balance of payments adjustment that has been used in several developing countries, although on the whole on a decreasing scale. Such a system, like exchange restrictions, may be used to protect an overvalued currency. It implies a system of subsidies and/or taxes on different types of exports, imports, and other international transactions. It can help to eliminate a deficit in the balance of payments, but, if applied over a long period, it is likely to result in distortions in the domestic economy by changing relative prices and, hence, patterns of production, away from those most conducive to welfare. It is true that some changes in relative prices away from a cost basis may be desirable from a welfare standpoint, but such changes can better be brought about by a well-conceived long-term fiscal program rather than through measures primarily designed to correct a balance of payments deficit.

Some remedies, then, for the balance of payments problems of developing countries, although they may appear attractive and have had wide application, are likely to be illusory. In discussing other remedies which experience has shown to be preferable, it is convenient to look at some of the difficulties which are in

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fact most typical of those experienced in practice by developing countries.

Temporary Shortfall of Export Receipts

A balance of payments deficit due to a temporary shortfall of export receipts is, in theory, a comparatively easy case. It is the type of deficit for which use of reserves and similar financing such as the resources of the Fund are designed. If one can be sure that the shortfall is temporary, and if reserves and other compensatory financing are sufficient to meet it, no measures to correct the deficit would seem called for. If a low level of reserves makes it necessary to reduce the gap in the balance of payments, temporary measures that are easily reversible, such as, for instance, import deposits or surcharges or a temporary application or intensification of restrictions, may be justifiable. The corollary of such a policy is that a temporary high level of export receipts should be permitted to work itself out into a surplus. It should not be accompanied by a relaxation of fiscal and monetary policies that would prevent a consolidation of the country's reserves.

This relatively simple prescription may be difficult to apply in practice because it is not easy to ascertain currently to what extent a shortfall in export receipts is temporary. By shortfalls in a discussion of this kind are meant not the amount by which export receipts in a given year fall short of those in the preceding one, but rather a shortfall related to the trend in the export receipts over a longer period. The trend may be rising or falling, but cannot be accurately determined until several years after the event. This is a difficulty that is met in the Fund when determining amounts that the Fund can provide under its compensatory financing facility.

Deficit Due to Unsatisfactory Long-Term Trend of Export Receipts

Balance of payments deficits of a more persistent character will arise if there is a falling trend in a country's export receipts over a long period due to circumstances beyond the exporting country's control. Unfortunately for the developing countries, there are many of this kind; mineral resources may become exhausted, for instance, or there may be a fall in international demand for one of a country's leading products. When such misfortunes occur, it is necessary to apply corrective measures; if the deficit were permitted to go on, reserves and other sources of compensatory financing would be depleted. A logical measure would be a depreciation of the currency to permit the balance of payments to become balanced without excessive application of restrictions or deflationary policies. An alternative would be an increase in import duties. This measure, in contrast to depreciation of its domestic currency, does not encourage a diversification of exports. In common with other measures affecting trade, increased import duties call for close examination and, where applicable, measures of renegotiation, under the General Agreement on Tariffs and Trade. These are among the obvious rational policies. But this is clearly a situation in which the application of rational policies may encounter resistance. In the short run it may be necessary to adjust the economy to a lower level of real income, something which may create political difficulty in many countries. Any measures to deal with the immediate balance of payments problems must, therefore, be supplemented with steps to improve the balance of payments over the long run, such as are discussed below.

Somewhat similar difficulties may arise where exports, without exhibiting a falling trend, merely stagnate or rise over the long run at a rate which is considered inadequate. In many developing countries the population rises at a rate approaching 3 per cent per annum, and a rise in exports at a lower rate than the growth of population, in the absence of increased foreign financing, implies a fall in per capita imports. Monetary demand, and hence demand for imports, does not, of course, rise automatically with the rise in population. The authorities of many countries may, however, apply policies that would permit money incomes to rise at least *pari passu* with population even though there is no corresponding rise in real income. Therefore, a slow export growth may be accompanied by a faster growth of import demand and, hence, pressures on the balance of payments. The prescriptions appropriate for this are similar to those that apply to that of declining export receipts, but less radical measures will do.

Deficits Due to Excess Demand

Deficits that have arisen as a result of excessive credit creation by the domestic monetary system can be corrected, if stability of the exchange rate is to be preserved, only through measures to re-establish monetary equilibrium. Balance of payments deficits primarily attributable to this cause are quite common and financial assistance by the Fund to correct these is frequently tied to a stabilization program. Stabilization programs may involve targets for domestic bank credit and the government budget to prevent any new creation of excess demand, as well as efforts to prevent an undue rise in wages. To be effective they often have to be accompanied by a depreciation of the currency to a realistic level.

Deficits Due to Overvaluation of Currencies

Where a country's balance of payments is in deficit because its currency is clearly overvalued (indicating a situation of "fundamental disequilibrium" in terms of the Fund agreement), the obvious method of balance of payments adjustment is a depreciation of the currency. If the depreciation required is considerable it may be difficult to decide what new par value would be appropriate, and in this situation the temporary application of a fluctuating rate may be justified. This may be advisable where a stabilization program is adopted after a period of rapid inflation.

Long-Term Balance of Payments Policy

The four typical causes of deficit in the balance of payments discussed above can be distinguished for purposes of analysis, but in practice are probably operating together. For instance, an unsatisfactory trend in exports may in part be attributable to inflationary conditions. Actual balance of payments situations may therefore require a combination of measures that are aimed at meeting immediate difficulties arising from a variety of causes but also at supporting the balance of payments over the longer run. It is important that temporary measures be so designed that they do not bring about distortions in the economy that make the application of rational long-term policies difficult.

The policies to deal with a long-term balance of payments problem may be divided into two broad groups; those that are directly aimed at improving the current balance, and those that are designed to increase the financial resources available for investment.

Measures Affecting Current Transactions

In a mechanistic sense, an improvement in the current balance, either through an autonomous increase in exports or through an autonomous decrease in imports, brought about, for instance, by production of import substitutes, has only a temporary effect on the balance of payments. It will take some time, however, before the rise in incomes has worked itself through the economy, and during the period of adjustment the current balance will be strengthened. If, moreover, the original improvement in the current balance is continued year after year, there will be a permanent improvement in the balance of payments in that the rise in import demand that results from the increase in national product will always lag behind the original improvement in the current balance.

This mechanistic explanation of the process of adjustment fails, however, to take account of one important aspect of the beneficial effect on the balance of payments that can be expected from autonomous improvements in current transactions. Insofar as these help to achieve a more adequate rate of growth they also help to lessen pressures for policies aimed at raising monetary income in excess of the rise in production.

To some extent the problems of improving the position of developing countries on account of current transactions cannot be solved by each country individually, but may require some sort of collective or broader international action (a topic outside the scope of this article). Nevertheless, a country must at any time make the best of the given opportunities, and there is something it can do in this respect by appropriate policies. There are, however, no easy prescriptions; such a course involves the formulation of long-term economic policies that take due account of the balance of payments. This requires, on the one hand, that development plans (e.g., in assigning priority to investment projects) give special attention to policies that can assist in raising exports and reduce the need for imports for which substitutes can be produced at home on a competitive basis. On the other hand, it requires that an economic climate be maintained that makes economic incentives effective.

In particular, a developing country must endeavor to diversify its exports. A country primarily dependent on one or a few export commodities is much more subject to fluctuations in export receipts than one whose exports are more diversified. Countries that have reached the stage of development where they can produce manufactured products on a competitive basis should pay special attention to measures to promote the export of such goods. Experience shows that inflationary developments make it much more difficult for countries to diversify their exports or even to maintain an adequate growth in their traditional exports. For instance, monetary stability makes it much easier to reduce costs in an export production, which may be necessary if the international price for the product is falling.

To promote exports some countries may subsidize certain products through the application of an especially favorable rate in a system of multiple exchange rates, a solution already discussed and found open to objection. A somewhat similar effect may be obtained through schemes whereby exporters in exchange control countries are permitted to retain a portion of the proceeds of their exports which they can dispose of themselves or sell in a free market. Countries contemplating the introduction of such a retention scheme, or the widening of any scheme already in existence, would be expected to ensure that it did not bring about such shifts in trade as might be damaging to other countries. Retention schemes whose only object is to simplify the administration of official exchange allocations are unlikely to have such consequences, but it should be noted that any encouragement to exports afforded by a retention scheme may be offset by other features of the exchange system, and the retention scheme may itself become a vehicle for a flight of capital.

A reduction in imports brought about by the development of import substitutes has, in principle, the same effect on the balance of payments as an increase in exports. A beneficial effect on the balance of payments can be expected only if the production of import substitutes is reasonably competitive, so that it does not need to be supported by unduly protectionist devices. In many cases this can probably be achieved best through some regional planning of industrial development, such as that initiated by the Central American republics. The beneficial effect on the balance of payments of such regional schemes comes in part through a reduction in imports and in part through an increase in exports to other participating countries.

Export growth and the production of import substitutes can often be supported by foreign capital, e.g., in the form of direct investment. This suggests that the balance of payments may be strengthened by creating a climate that encourages foreign investment.

Measures Affecting Savings and Investment

To strengthen the balance of payments over the long run it is equally important to direct policies toward stimulating domestic saving. To achieve equilibrium in the balance of payments in the short run it is necessary, through measures of fiscal and monetary policy, to limit domestic capital formation to the financing available through domestic saving and foreign (noncompensatory) finance. Experience suggests that the most effective way in which governments can hope to raise permanently the level of saving in the economy is to combine policies of monetary stability with efforts to rationalize their fiscal systems through better expenditure control and fiscal reform. In the Fund the realization that this is necessary to support exchange stability has led to the establishment of an advisory service on fiscal problems.

The extent to which a country can receive foreign financial resources to support its balance of payments and development effort is to a considerable extent decided abroad, and the decision to some extent depends on noneconomic factors. A country can, however, through its own policies make it more or less attractive for foreigners to make private capital available to it. From this standpoint, it is particularly important that monetary and exchange stability be maintained. Where inflation prevails the inflow of foreign capital is discouraged, perhaps because the pressures on the balance of payments with which inflation is necessarily accompanied add to the risk of foreign investment. It makes it doubtful whether the investor can count on remitting income and amortization of his capital. Inflation may also stimulate a flight of domestic capital. The contribution which foreign financial resources can make to supporting the balance of payments and economic development is substantial, as is the disruptive effect that can result from a flight of domestic capital in an inflationary situation.

At the same time, it can also be dangerous to a country to become overindebted because of an excessive inflow of foreign capital, in particular, if it is received on terms that are out of line with the investments it finances. This is a problem to which the World Bank has over the years given considerable attention and which is of increasing concern to the Fund. While an inflow of capital is always of immediate benefit, it may present a future problem if the terms of interest and amortization are not adapted to the servicing capacity of the debtor country. The terms on which foreign financial resources are provided, are, therefore, of overriding importance, but they are not necessarily related to the economic performance of the country importing capital.

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