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GRAHAM BIRD: "SHOULD DEVELOPING COUNTRIES USE CURRENCY DEPRECIATION AS A TOOL OF BALANCE OF PAYMENTS ADJUSTMENT? A REVIEW OF THE THEORY AND EVIDENCE AND A GUIDE TO THE POLICY MAKER" — JOURNAL OF DEV. STUDIES, VOL. XIX, NO. 4, JULY, 1983.

In the article, Bird summarises existing theoretical and empirical literature on the merits of the use of currency depreciation as a tool of balance of payments (bop) adjustments. In line with the posture of the International Monetary Fund (IMF) he argues that besides getting price incentives right, exchange rate depreciation often elicit the desired supply and demand responses for exports and imports. This effect is usually reflected even in short run correction of bop deficits, a situation he contends augurs well for developing economies. The article was rendered in five parts.

Part I is the introduction to the subject. In it, the author notes that exchange rate realignment usually formed the high point in negotiations for Structural Adjustment Financing between the IMF and developing countries, because many countries fear its political consequences, even in the face of large bop deficits, which require reforms.

Part II focuses on the theoretical framework for analysing bop problems with respect to exchange rate depreciation. Relying on the elasticity and monetary approaches, Bird maintains that depreciation can help to correct domestic price distortions and bop disequilibrium by increasing the price of imports and/or cheapening exports as well as reduce absorption. Under the elasticity approach, the ensuing price effect reduces demand for imports while raising domestic demand for import substitutes. It also increases foreign demand for local exports, reduce local demand for exportables as well as increase export production. In his view, for developing countries which produce primary goods the price of which is quoted in foreign currency, the critical response is the export supply response. Further, the responsiveness of imports to price changes following depreciation, depends on the degree of distortions caused by exchange control regimes. On balance, he argues under the elasticity approach, that the sum of foreign demand elasticity for exports and domestic demand elasticity for imports must exceed unity for depreciation to have a net positive effect on the balance of payments. Drawing from a variety of studies the author indicated that relative price changes do occur following exchange rate realignment, while at the same time eliciting volume and value response in both exports and imports. He held that non-traditional exports such as agricultural produce of short gestation, minerals and manufactures tended to respond more strongly than traditional exports in the short run even though both traditional and non-traditional exports usually had long run elasticities above zero.

On the monetary front, the author notes that devaluation reduces real expenditure on the one hand, because domestic currency expenditure on imports increases due to inelastic demand, resulting in a reduction in aggregate demand for domestic output. Secondly, depreciation redistributes income in favour of the trading sector, leading to lower domestic expenditure, as a result of a lower propensity to spend out of profits than of wages. Thirdly, he contends that with the advent of external debt problems, higher debt service tend to reduce domestic expenditure as domestic currency counterpart to foreign debt service rises astronomically. Thus under the monetary approach, depreciation acts in a multi-dimensional way as an expenditure and resource switch as well as expenditure reducer.

In part III, the author appraised the effect of depreciation on the balance of payments by making the conventional distinction between the current and capital accounts. On the current account, he notes that the elasticities are usually adequate to strengthen the current account balance. He cautions however that the possible cost inflation may actually cause an appreciation of the real exchange rate over time. He was further of the opinion that while initially depreciation reduces domestic expenditure and absorption, of which the current account balance is part, it will raise real output in the traded goods sector in the long run. With prospects of a long run positive current account balance, he posits that a distinction ought always to be made between the long run and the short run in appraising the effect of devaluation on the current account. On the capital account, he held that if among other things depreciation allows a relaxation of import and exchange controls, it could also improve the capital account through the induced capital inflows and investments.

Part IV attempts to make comparison between depreciation and four other balance of payments adjustment theories. With fiscal simulation policies such as tariffs, multiple exchange rates, taxes and subsidies, the author is of the view that they are attempts to protect preferred sectors of the economy but usually fail because of the difficulty of policing and ensuring fiscal discipline. Similarly he notes that credit controls and monetary management alone are usually inefficient as they tend to leave relative prices unchanged whereas depreciation achieves both effects. The case for exchange controls in his opinion is not better as it tends to suppress rather than address balance of payments problems. Furthermore, controls shift factor intensities in favour of capital while creating economic rent for import license holders. Finally, the author notes that the structuralist view of inducing growth poles, creates policy biases towards preferred sectors to enhance supply of resources and products. It has the tendency however to be frustrated by unrestrained domestic demand and inappropriate financial policies, whereas depreciation combines both structural and demand management effects.

In the concluding remark, the author notes that evidence abound to indicate that an active exchange rate policy will strengthen the balance of payments. Devaluation though necessary, is not a sufficient condition for sustained export growth and balance of payments improvement. It needs to be complemented by supporting monetary and fiscal policies such as export taxes, wage increases and short term subsidies. Once established the author recommends frequent nominal exchange rate movements to maintain an equilibrium real exchange rate. He further held that depreciation will be more effective where the payments deficit is relatively large and of a structural nature rather than of financial origin.

COMMENTS

The structure of the paper especially its emphasis on the secondary effects of depreciation makes it very relevant to developing countries going through structural adjustment programmes. The main hinge is on the elasticities of import demand as well as export demand and supply to the price effects of devaluation. The sluggish response of developing economies' exports to devaluation, reflects constraints which price incentives alone cannot fully address. The basic assumption under both the elasticity and monetary approaches is factor mobility. This has proved very difficult to realise, and thus threatens the responsiveness of both export supply and import demand. Responsiveness in export supply and import demand require changes in the production functions of export producers and import substituting industries. While factor ratios vary only slightly in export production resulting in the generally inelastic supply response shown in the appendix to the paper, imports are more resistant to variations due to the capital using technologies in the existing import substituting industries.

In spite of the seriousness of the external indebtedness of many developing countries, the author did not provide an insight into the practical problems encountered, especially as foreign exchange receipts may actually decline following a devaluation. Interest payments on external debt usually are inflexible and for practical purposes do not respond to exchange rate realignment.

However, from Nigeria's experience under the Structural Adjustment Programme, exchange rate realignment actually shrank the import bill significantly thereby turning the balance of trade around. The non-oil export list has also grown considerably. Significantly, the pattern of exports showed non-traditional exports responding strongly in volume and value terms.

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