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Exchange Rate Action: Channels of Contribution to Effectiveness of Growth-Oriented Adjustment Policies in Low Income Primary Producing Countries

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EXCHANGE RATE ACTION: CHANNELS OF CONTRIBUTION TO EFFECTIVENESS OF GROWTH- ORIENTED ADJUSTMENT POLICIES IN LOW-INCOME PRIMARY PRODUCING COUNTRIES

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This paper identifies exchange rate as one of the principal policy tools through which low-income primary-producing countries could properly align their economic and financial activities with those in the rest of the world to achieve satisfactory growth in income and employment. It examines the channels through which devaluation (exchange rate action) can produce significant impacts on major economic aggregates and in the process, correct financial and structural imbalances. Firstly, devaluation sets in motion a market-driven process of asset reconstitution which can contribute to an improvement of the devaluing country's balance of payments through an increase in export earnings (impact on profit margins in foreign exchange earnings, measured in domestic currency). Secondly, devaluation can help redress deficits in external finance by raising the prices of imported goods, thereby curtailing the demand for them. Thirdly, the upward impact of devaluation on the total cost of the domestic industrial sector (in domestic currency) should be less than its impact on imported goods, thus resulting in domestically produced industrial goods being relatively less costly than comparable imports, leading to a switching of demand in the devaluing country, from imports to less costly domestic goods. Fourthly, employment, in sectors with increased price of foreign exchange (entailed by devaluation) and reduced demand for output would be adversely affected, while it would expand in sectors experiencing increase in demand. Fifthly, in the area of government budget, the net budgetary impact of devaluation would depend on the relative magnitudes of outlays and receipts on external debt-related operations. Finally, devaluation could induce higher inflows of capital, as it can encourage providers of previously curtailed lines of credit. The paper cites arguments used to deprecate devaluation in low-income primary-producing countries to include limited elasticity of supply of primary export goods with respect to domestic-currency price incentives through devaluation and the limited practical scope for compression of import. While conceding that problems exist in these areas, it maintains that full consideration of export possibilities of devaluation needs to include commodities not yet on the export list and that devaluation helps to promote a more efficient allocation of import resources. The paper concludes that as a pricing policy instrument, devaluation affects the value of financial and non-financial assets in an economy, and it is through the markets in these items that it contributes to restoration of financial balance and revival of economic growth. It also stresses that the various channels for its possible contributions in relieving external payments pressures suggest that devaluation can be a helpful instrument of adjustment policy in all countries.

INTRODUCTION

Among the multiple challenges facing policy authorities in low-income primary-producing countries are the correction of financial and structural imbalances in the economy, and the achievement of satisfactory growth in income and employment. These countries' institutional and economic characteristics (including export concentration on a few agricultural or mineral products for which they are price-takers in the world market, dualism in structural links between rural and urban sectors, and a relatively high degree of dependence of investment and economic growth on imports of foreign goods, capital and technology) underline the strategic importance of a proper alignment of their economic and financial activities individually and collectively with those in the rest of the world. Among the principal policy tools for such alignment is exchange rate policy.

As a measure of the formal purchasing power of domestic money over internationally traceable goods and services, the exchange rate of the national currency has the distinction of being among the most broad-reaching financial indicators, rendering changes in the rate at once potentially extensively effective economically and widely-impacting socially and politically. Accordingly, the question of the economic merits of policy action to change the exchange rate commands serious attention among a broad spectrum of participants in economic activity, including consumers and producers, savers and investors, rural and urban sectors, and exporters and importers.

Focusing on action to increase the domestic-currency price of a specified unit of

foreign currency (or, equivalently, to decrease the foreign-currency price of a unit of domestic currency), i.e. devaluation, this analysis examines the channels through which such exchange rate action can produce significant impacts on major economic aggregates and sectors, thereby helping to correct financial and structural imbalances and facilities growth in the economy. Section II analyses the nature and interrelationships of the various channels through which exchange rate action induces economic behaviour responses that contribute to the correction of maladjustments in the economy. Section III discusses some arguments commonly adduced to deprecate devaluation as a tool of adjustment policy, especially in primary-producing developing countries. Section IV contains the paper's conclusions and adjustment policy implications.

II. Impact Channels of Devaluation.

Overall, devaluation involves, inter alia, a reduction in the price-adjusted value of an important component of the asset-portfolio of individual asset-holders in the economy i.e. a deterioration in the value relationship of domestic financial assets (i.e. liquid assets, or money broadly defined) vis-a-vis non financial assets in the individual holder's total portfolio. To the extent that the predevaluation structure of overall asset holdings represented what asset-holders actually wanted to hold, devaluation would set in motion a market-driven process of asset reconstitution in the form of trading nonfinancial for financial assets, and the increased supply of nonfinancial assets in the absence of increased internal demand would put a downward pressure on the domestic market prices of such assets. Even where the predevaluation supply of domestic financial assets in the economy can be deemed "excessive", some degree of such portfolio adjustment may be expected to occur with devaluation, as would also happen when the margin of devaluation significantly exceeds the pre-devaluation degree of excess domestic liquidity. This reconstitution process can contribute to an improvement of the devaluing country's balance of payments in at least two ways: (i) the induced trading of nonfinancial for financial assets would generally involve increase selling to nonresidents i.e. an increase in export earnings, and (ii) reconstitution would also spur pressures for increase import of funds by residents or, equivalently, export of IOUs i.e. higher inflows of capital.

Conversely, among financial assets, the increased price of the foreign-currency component due to devaluation can be helpful to the economy and the balance of payments in a number of ways: for example, the higher price of foreign currency will normally stimulate generalised economy in its use, making it possible to attain a higher volume of economic activity with an unchanged amount of foreign-currency resources i.e. increase in productivity. Thus, even if imports had been curtailed to an irreducible minimum, devaluation can nevertheless be helpful to economic growth and the balance of payments through this uplifting effect on productivity. Where the prevailing state of business organisation, equipment, and technique makes additional substitution for imports feasible in the short run, devaluation-induced in the domestic prices of imports will normally stimulate increased production of import substitutes, thereby substituting the employment of domestic for foreign labour in the production of such components of total internal demand. In any case, to the extent that devaluation induces an increase in capital inflows (e.g. through the channels described in the preceding paragraph), it will make it possible to achieve a larger volume of imports (including imports of producer goods), and thereby a higher rate of economic growth

than otherwise possible. In the rest of this section, the impact channels of devaluation are further examined on a sector by sector basis.

(a) Devaluation & Exports

For a developing country whose exports are predominantly in the form of primary commodities the foreign-currency prices of which generally are determined by external market conditions, the significance of devaluation of the domestic currency lies, not in its effect on the external prices of the primary goods exports, but on its impact on profit margins (measured in domestic currency) in foreign exchange earning or saving industries in the devaluing country. In the absence of controls on producer prices, domestic-currency receipts from a unit of foreign-currency earnings from exports will increase by the percentage margin of devaluation of the home currency; and assuming all else unchanged, this will lead to an improvement in profit margins and production incentives in the export sector. Should production costs rise simultaneously with devaluation, the improvement in profit margins would, of course, be correspondingly reduced. In cases where harvestable export crops had been neglected because of inadequacy of incentives, including severe shortage of essential import goods due to foreign-currency constraints, even a modest improvement in profit margins made possible by devaluation could lead to significant increase in exports supply, if imports of such incentive goods could increase following devaluations.

The profit-enhancing possibilities of devaluation of the domestic currency in such an economy are, of course, ultimately related to the evolution of demand conditions for primary products in the world market. For example, with a 50 per cent devaluation of the local currency vis-a-vis the U.S. dollar, the impact on exporters' local-currency receipts and profit margins would be generally neutralised if simultaneously there were to be a 50 per cent decline in the U.S. dollar prices of such exports in the world market. In this respect, it would be useful to distinguish between individual primary export producers and the export sector as a whole: irrespective of external price developments, the improved domestic financial incentives stemming from devaluation can be expected to spur the more efficient and aggressive producers to expand export volume, while a decline in the foreign prices of exports contemporaneously with devaluation may well push some less efficient, marginal producers out of such an export sector altogether. Since those (business proprietors, workers etc.) exiting from the traditional export sector will presumably seek to be more profitably deployed elsewhere, devaluation under such circumstances provides an inducement toward a better allocation of resources in the devaluing country. Thus, a number of nontraditional items unprofitable to produce and export at the pre-devaluation exchange rate, would become viable products for the export market with the increased local-currency earnings from a given unit of foreign currency after devaluation.

As in other policy areas, the above-noted possibilities are subject to some important caveats. For example, it is important to ensure (through exercise of due restraint in public spending, and in wage awards as well as in banking system credit to the private sector, etc.) that production cost increases at home remain well below the percentage margin of devaluation, in order not to jeopardise post-devaluation profit margins in sectors producing internationally traceable goods. To the extent that domestic consumption and investment have significant import content, devaluation can be expected to entail some increase in domestic prices; but such prices needs not rise pari passu with devaluation, especially where there has been a large unofficial foreign exchange market

whose exchange rate has effectively determined prior to devaluation, the conversion prices for import goods. To the extent that foreign exchange has been a severe constraint, external assistance to facilitate import flows would help to keep down inflationary pressures in the immediately post-devaluation period. Ironically, devaluation's success in pushing traditional and/or nontraditional exports can have a rebound upward effect on he internal price level, such as would happen if devaluation makes it (more) profitable to export items traditionally consumed locally, or induces a significant shift of productive resources from home-market to export-market items within a relatively short time.

Capacity and physical constraints are also among the factors affecting the effective ameliorative impact of devaluation on profit margins in the export sector. Existence of unused productive capacity in the export sector would enable exporters to respond to the devaluation-induced improvement in incentives by increasing export volume without much loss of time; otherwise, the need for exporters to bid away resources (including labour) from other sectors would put upward pressure on costs and prices, thereby undermining the effective benefits from the improved incentives. Similarly, where infrastructural facilities (e.g. rural-urban transportation) are seriously wanting, increase in export volume could force up user charges for such facilities, such that the bulk of enhanced profits would accrue to backward-or forward-linked sectors (e.g. internal marketing or transportation companies) rather than to exporters as such. Credibility of the policy authorities also comes into play once capacity expanding and other decisions involving time horizons beyond the immediate period have to be considered by exporters and others: only if the devaluation-improved prospects for profits are expected to prevail substantially for a reasonable period (i.e. if policy authorities appear credibly committed to, and capable of, carrying through with the announced reform measures) will business decision-makers in the export sector deem it worth their while to commit present resources for the purpose of future increases in export. In other words, expectations of decision-makes in export (as indeed in other) sectors about the behaviours of internal costs and prices in the economy in the post-devaluation period must be reasonably stable. These considerations apply with particular force with respect to prospects for breaking new grounds in export markets i.e. promotion of nontraditional goods.

(b) Devaluation & Imports

As noted above, a direct channel whereby devaluation can help in redressing deficits in external finances is by raising the prices of imported goods more or less in line with devaluation, and thereby curtailing the demand for such goods. Even where imports in the pre-devaluation period consisted of minimum necessary items, devaluation's inducement toward greater economy in the use of foreign exchange resources could lead to a higher level of economic activity for a given amount of foreign exchange and/or freeing-up of foreign exchange funds for other uses. Depending on how far import prices rise as a result of devaluation, the import bill would also be relieved by the switching of domestic demand to import substitute goods which should be relatively cheaper, even with due allowance for the use of imported inputs in the production of such substitutes.

In the short run, before consumers and producers have time to react to devaluation induced changes in the relative prices of home- and foreign produced goods, the total import bill may not decline appreciably; but, for reasons already stated, devaluation

may be expected to induce moderation of import growth in due course, provided that policy steps are taken to avoid unsustainable growth of total internal demand.Overall, devaluation need not, however, entail diminution of imports in a developing country characterised by dependence of investment on imports of machinery and equipment and other inputs, the critical factor being devaluation's inducement toward increased efficiency in resource allocation: where devaluation-related improved price incentives succeed in generating a substantial and speedy increase in productive resources (including foreign exchange), and if little or no unused capacity exists in the economy, revival of economic growth following devaluation could entail increase in import volume; but with sufficiently strong positive supply response to devaluation, such increase in imports could be combined with an improvement or at least lack of deterioration in the foreign trade balance.

Devaluation can also contribute toward improvement in external finances via its impact on demand for noncommodity imports, i.e. services. Uneconomic pricing of foreign exchange prior to devaluation usually leads to unsustainable growth in the demand for foreign-produced services such as outward nonbusiness travel, subscribing membership in foreign association, various levels of studying abroad, and extensive network of foreign diplomatic representation. By raising the domestic-currency price of foreign currencies, devaluation encourages residents of the devaluing country to economise in the use of such foreign exchange-intensive services, thereby helping to reduce the overall import bill. Irrespective of the tightness of the room for manoeuvre in regard to commodity imports, there commonly would be considerable room in developing countries for foreign exchange savings through market-driven substitution of domestic for foreign services.

(c) Devaluation & the Domestic Industrial Sector.

Devaluation affects the demand and supply sides of the industrial sector in various ways. Domestic industrial producers will experience increase in their costs up to the extent of their respective dependence on imported inputs; but since the import content of their production activity would be less than one hundred per cent, the upward impact of devaluation on their total cost (in domestic currency terms) should be less than its impact on imported goods which by definition have full import content. Thus, other things being equal, devaluation should result in domestically produced industrial goods being relatively less costly than comparable imports, which should in turn lead to a switching of demand in the devaluing country, from imports to less costly domestic goods.

Because devaluation deflates total internal demand to the direct extent of its downward effect on the external purchasing power of domestic money, it may be feared that the improved competitiveness on the supply side of the domestic industrial sector would meet with enfeebled demand. On the contrary, and as noted above, devaluation gives a stimulus for expansion of production and income in the (primary) export sector which contains the bulk of the potential for growth of demand for industrialgoods in a developing country. In any event, by increasing the domestic-currency value of foreign exchange, devaluation strengthens the incentive for industrial producers in the devaluing country to tap demand potentials abroad in the form of exports of non-primary goods exports. When aggressively pursued, the various elements of possible demand increases for domestic industrial goods may more than offset the downward effect on internal demand stemming from devaluation.

Realisation of the growth potential of the domestic industrial sector following devaluation, however, depends critically on ability to hold the line on domestic production costs. With devaluation already pushing up the cost of imported inputs, it is important that profit margins in the sector not be further threatened by permitting increases in other costs, notably wages. These caveats require that policy authorities in the devaluing country refrain from public-sector spending policies that would put inflationary pressures on internal costs and prices.

(d) Devaluation & Employment

Its general incidence on total demand in the economy, and its impact on specific sectors (exports, imports, domestic industrial production, and services) are among the various ways in which devaluation affects the volume of employment in the devaluing country. To the extent that the increased price of foreign exchange entailed by devaluation leads to demand reduction for the output of certain sectors, employment in such sectors would of course, be adversely affected. As against such tendencies, however, employment opportunities in sectors experiencing demand increase as a result of devaluation would expand. Thus, substituting domestic production for import made relatively more expensive by devaluation should help to increase employment opportunities in the devaluing country. Similarly, enhanced profit margins in export production due to devaluation can be expected to lead to increased demand for labour in that sector; indeed given the relative unattractiveness of rural working conditions in low-income primary producing countries, the problem under devaluation propelled stimulus to exports might well be that of being able to attract an adequate supply of labour to the primary export sector without provoking an increase in wages. In this context, the effectiveness of devaluation would be enhanced by increased capacity (e.g. via external financial assistance) to import basic consumer items, and thereby help to moderate upward pressure on living costs and wage rates in domestic currency terms.

Devaluation can, in principle, also help to promote increased employment through its upward impact on the local-currency cost of imported machinery and equipment, thereby tilting the balance in favour of labour-intensive methods of production. Such tendencies would be reinforced by contemporaneous increase in domestic interest rates, for consistency in reducing pre-devaluation biases in favour of capital in the choice of production techniques.

In considering the possible beneficial effects of devaluation on employment, it is important that the emphasis be placed on increase of wage labour rather than of wage rates. By undermining newly enhanced profit margins in the relevant business sectors, wage rate increases under devaluation would tend to neutralise possible benefits in t he form of growth in business demand for labour. At any rate, since ultimately external financing deficits can be corrected only by curtailing the excess of total spending over total output in the economy, and given the general tendency to spend proportionately more out of wage was compared to profit income, letting internal wage rates increase following currency devaluation would run counter to the objective of promoting internal savings as a means of curtailing deficit spending on external accounts.

(e) Devaluation & Government Budget.

Its impact on government revenues and expenditures are also among the ways in which devaluation contributes to adjustment and growth in an economy. As in the case

of the private sector, government's expenditure on goods and services includes import contents (purchase of materials and supplies, foreign travel, diplomatic representation abroad, etc.) in varying degrees. Devaluation-induced increase in the domestic-currency prices of such import components should normally help to hold down government spending on such items, thereby contributing to an improvement in budget deficits. Among other public-sector outlays, devaluation clearly increase the domestic currency cost of foreign exchange for amortisation and interest payment obligation on external debt; but so also does it raise the domestic currency equivalent of new drawings of externally provided funds: the net budgetary impact would depend on the relative magnitudes of outlays and receipts on external debt-related operations. Where, as usually happens, serious implementation of devaluation and other reform measures succeeds in attracting increases in external financial assistance, including possible debt relief, the net effect of devaluation on the external debt content of budgetary operations would be positive.

Among the budgetary revenue items that are directly sensitive to devaluation, its effects on receipts from import taxes are generally indeterminate, turning partly on the responsiveness of internal demand to the higher local-currency prices of imports, availability of foreign exchange for import financing, and ease of domestic credit for import cover. All else remaining unchanged, if the price sensitivity of domestic demand for imports is negligible, and provided that import tariff rates are largely on an ad valorem basis, the higher prices of imports in local currency terms due to devaluation would lead to an increase in import tax collections, as the volume of imports would be little affected. Even if total import demand, being price-sensitive, were to decrease as a result of devaluation, import tax collections need not decline if import structure, as is not implausible, changes toward the relatively higher-taxed items, though the direction of change may equally well be the opposite.

Among other positive entries in the budget, devaluation would also raise the domestic-currency value of foreign-currency grant inflows, which in addition generally tend to increase even in foreign exchange terms as part of external assistance in support of adjustment efforts. Budgetary revenues also benefit from devaluation when specific traditional export items whose production was already reasonably competitive before devaluation, are made liable to export taxes as a means of offsetting gratuitous favourable impacts of devaluation on profit margins in such sectors.

Taken together, the possible effects noted above can be expected to add up to a net positive impact of devaluation on public finances in the devaluing country. Overall, much would depend on the extent to which the responses of public policy authorities to the price changes stemming from devaluation are in line with normal expectations, including the exercised degree of spending restraint in the face of increased local-currency prices of imported goods and services. This means that effectiveness of devaluation on the budgetary front is linked closely to the degree of implementation of financial discipline by the policy authorities.

(f) Devaluation & External Capital Flows.

As regards external debt components of capital flows, and as noted above, devaluation undoubtedly aggravates the domestic currency burden of servicing a given amount of foreign-currency obligations. On the other hand, devaluation can work through various channels to effect increase in the wherewithal to meet external debt and other foreign-currency payments. In addition to the above-noted possible increases in

existing official-sector export earnings, by moving the official price of foreign currency to a more realistic level, devaluation helps to attract foreign exchange supplies away from unofficial to official channels, making more resources directly available for debt servicing and other uses. In the context of a credible program of policy reform, devaluation also usually succeeds in opening doors to various debt-related benefits, including debt rescheduling and debt reduction which thus free up available foreign exchange for other uses.

Foreign capital inflows through other channels also stand to benefit from devaluation. For example, by lowering the foreign-currency cost of local resource components of investments projects in the devaluing country, devaluation helps to enhance the attractiveness of the economy to international investors, including private direct investment, inward remittance of funds by non-resident nationals, and export development projects. In combination with appropriate domestic interest rates, devaluation of the home currency can also assist in attracting nonproject-related funds (e.g. portfolio investments) into the domestic financial systems. Generally speaking, and as noted at the beginning of section II above, importation of funds from abroad provides one means whereby residents of a devaluing country can seek to restore to pre-devaluation levels, the post-devaluation relationships between their holdings of financial and other assets in the economy.

Among other elements in the flow of external funds, by signalling a more economical pricing of a scarce resource, devaluation can encourage providers of previously curtailed lines of credit (e.g. export or import financing credit) to re-open them, or facilitate the opening of new ones. For the managers of a country's external financial assets, devaluation effectively helps to relax the external financing constraint by raising, in local-currency terms, the import-coverage capacity of even a given amount of foreign exchange reserves.

III. ISSUES OF DEVALUATION SKEPTICISM.

Skeptics about the merits of devaluation in low-income primary-producing countries typically anchor their case on two points: limited elasticity of supply of primary export goods with respect to domestic-currency price incentives offered through devaluation, and very limited scope, in practice, for compression of import demand in low-income primary-producing countries experiencing external payments difficulties. Undeniably, production of many primary export goods (including long-gestation tree crops like cocoa and coffee) cannot in the short run be increased in immediate response to devaluation's enhancement of profit margins in the export sector; but even in such a relatively short time-frame, the supply of such goods can be augmented in the form of furnishing through official channels, export items which, but for the exchange incentives offered by devaluation, would have been sold through unofficial conducts. While such rechannelled resources may not necessarily constitute a net addition to the aggregate of foreign exchange availability to the economy, they are advantageous in several respects, including: (a) bringing such resources within the formal financial system helps to ensure their availability to the most productive user at the margin on an economy-wide basis, and may help to ease foreign exchange management by the authorities; and (b) by expanding the volume of formal-sector activities, such rechannelling helps to broaden the base for budgetary revenues, thereby contributing to achievement of financial stability.

Full consideration of the export possibilities of devaluation would also need to

include prospects for exporting commodities not yet on the export list. Since, in local-currency terms, devaluation renders it relatively more profitable to export as compared to the home market, it impels businesses in the devaluing country to search for ways of strengthening profits by selling nontraditional export goods abroad-a possibility frequently overlooked by devaluation pessimists who tend to concentrate on responsiveness of traditional exports to devaluation. As long as production cost changes are not more disadvantageous for nontraditional exportable items than elsewhere in the economy, devaluation would trigger market pressures toward incremental allocation of resources for such export diversification.

On the import side, to downplay possible contribution of devaluation on the grounds of import payments having already fallen to an irreducible level (i.e. alleged price-inelasticity of demand for imports) is to make an economic problem look as if it were an engineering one: following devaluation, the domestic-currency prices of imported goods will normally rise in varying degrees around the percentage margin of devaluation, depending on a number of factors, including (a) the extent to which suppliers abroad continue to stick to pre-devaluation foreign-currency prices and other selling terms; (b) the prevailing state of domestic inventory of the respective import items at the time of devaluation; and (c) importers' profit margins at the time of devaluation, and whether such margins are maintained during the post-devaluation period.

Given that import prices are thus likely to rise by different margins as a result of devaluation, domestic demand for imported goods can be expected to respond accordingly i.e. devaluation affects not just the level but also the structure of import payments. Since the changing structure of import demand would be generally motivated by a desire to economise in the use of import items rendered variously more expensive by devaluation,it follows that devaluation helps to promote a more efficient allocation of import resources; in other words, even if overall imports were not to change significantly in response to their higher domestic-currency prices stemming from devaluation, their composition would- in a manner amounting to a better allocation of resources.

Skeptics about the possible effects of devaluation on commodity exports and imports also tend to overlook noncommodity channels through which devaluation can assist in the adjustment process. All international flows of receipts and payments sensitive to price changes (i.e. those channelled through the market system) are affected by devaluation. Accordingly, rational economic behaviour on the part of residents and non-residents of a devaluing country would normally lead to changes in most of the components of the country's international accounts. For example, as previously noted, by making local currency-denominated activities cheaper in foreign exchange terms, devaluation can be expected to trigger increased inflow of funds in such areas as tourism, private inward remittances by nationals working abroad, and inward private foreign investments. The entire picture of a country's international accounts would also gain in transparency as a result of devaluation, as transactions previously funnelled through unofficial channels would be lured to official channels by more attractive new prices; in other words, devaluation would help in sanitizing the repository for unplaceable (or residual) flows in a country's international accounts - the so-called errors and omissions elements in balance of payments presentations.

It would, of course, be rash to claim, a priori, that a devaluing primary-producing developing country would reap favourable result from all of the impact channels of devaluation examined above. On the other hand, it would be equally rash to deny that

the normal tendency would be for the rationally expected impacts of devaluation to prevail in these countries, at least in most cases.

Nothing in the foregoing is, however, intended to imply that devaluation is a problem-free solution to external financial difficulties. As inflation undermines the domestic purchasing power of the national money, so also prolonged eternal payments deficits typically reflect, effectively,declining external purchasing power of a currency in relation to the officially declared exchange rate. In principal, both problems can be solved solely through firm pursuit of domestic demand-restraining policies i.e. cutting back sizably on total spending in the economy. For example, at the extreme, if aggregate demand in the economy were somehow to fall to nil, all available good and services in the economy would be destineable for export markets, thereby helping to close eternal payment gaps. To the extent that internal policy considerations (e.g. employment, economic welfare, or prevailing poverty levels in specific sectoral groups) set a limit on such deflation-only approach, the case for devaluation would arise in situations of unsustainable external payments deficits.

However, since, strictly speaking, it involves taxing away a part of the external purchasing value of the public's money holdings, devaluation is a policy instrument that could hardly be applied very frequently without provoking the public to search for and adopt self-protection mechanisms e.g., import hoarding, outward capital flight, or other forms of devices aimed at evading present or prospective devaluation "taxes". It follows that, generally speaking, devaluation would work best when applied in a manner that could reasonably lead the public to believe that it would not be repeated frequently: credibility of the initial percentage devaluation and of the adequacy of accompanying measures is of critical importance in this context. where prospects for achieving such credibility do not appear promising, it would be more advantageous in the long run to use the exchange rate of the local currency as a stable reference point (or anchor) for other market transactions in the economy, provided that policy execution in other related areas would be adequate for restoration of sustainable internal and external financial stability in the context of reasonably satisfactory economic growth, and provided critically that back-up resources in the short term (in the form of foreign exchange reserves and other mobilizable external financing) are reasonably dependable.

IV. CONCLUSION & IMPLICATIONS.

As a pricing policy instrument, devaluation literally affects the value of financial and nonfinancial assets in the economy; and it is through the markets in these various items that it contributes to restoration of financial balance and revival of economic growth. With due allowance for the well-known distinctive characteristics of low-income primary-producing countries, including those relating to gestation periods in export production as well as to stage of general economic and institutional development, devaluation works in these countries in much the same way as it does in more advanced countries. Everywhere, devaluation directly reduces the purchasing power of domestic money holdings over internationally traceable goods and services, thereby triggering moves by affected parties to reconstitute their positions. Such moves would ordinarily include efforts to mobilise additional holdings of funds through commodity exports or capital inflows, and to economise in the use of foreign exchange through import substitution or market-induced restructuring of import spending focused on higher priority items.

Among markets for commodities and services as such, devaluation also strengthens market incentives for increasing net earnings of foreign exchange. In low-income primary producing countries, while it is true that the production of export crops (such as cocoa, coffee, or tea) would take time to respond to improved profit prospects (in local currency terms) offered by devaluation, the supply of such exports could increase even in the short term through more intensive exploitation of existing production possibilities or the recanalization to official channels, of previously smuggled exports. Devaluation-induced enhanced value of foreign exchange in relation to domestic currency would also help to attract productive resources into the export sector. Increased export of services is another channel through which devaluation can contribute to an improvement in the external financial situation: for example, the reduction in the foreign-currency price of local money would make incoming tourist visits more internationally competitive in the devaluing country, and similarly for inward foreign investments.

Other possible ways for devaluation to contribute to an improvement in the economic and financial situation include: (a) increased incentive to employ local labour, as devaluation lowers such costs in relation to domestic-currency costs of foreign labour and machinery; (b) benefits in the form of increased local-currency value of the foreign exchange components of budgetary receipts (e.g. royalty income from mining production, foreign grants, and taxes on foreign trade), which may be variously offset, depending on the extent to which the foreign-currency contents of budgetary expenditure are restrained in response to their higher local-currency prices; and (c) greater domestic-currency value of debt-related inflows, combined with possible foreign exchange savings from external debt relief in response to devaluation and other adjustment efforts which together, in cases of strong and credible efforts, can be expected to exceed increase in domestic-currency cost of external debt servicing following devaluation. Overall, as a move toward a more realistic pricing of foreign currencies, and by helping to attract external-sector transactions from the underground economy into official channels, devaluation contributes to increase transparency of economic activity in the devaluing country, thereby enhancing the information base for decision-making by interested parties at home and abroad and thus contributing to better allocation of resources.

The essence of adjustment in its external dimension being elimination of the excess of total national expenditure over total national output, devaluation is strictly neither necessary nor sufficient for realisation of such objective: compression of total demand through fiscal, monetary, and other policies would, in principle, attain the same goal. By strengthening incentives for net expansion of foreign demand for home output, devaluation helps to assuage the impact of domestic demand-restraining measures on internal employment and welfare. Because it effectively involves a levy on the external purchasing power of domestic money holdings, however, devaluation cannot be frequently applied in a country without provoking protective reactions on the part of the affected population, thereby undermining possible effectivenes of such a policy measure. Accordingly, in situations that cannot credibly promise infrequency of devaluation in the near term, prospects for restoration of external balance and non-inflationary economic growth may be better served by holding the exchange rate on a stable anchor, while relying on changes in fiscal, monetary, and other policies for the pursuit of adjustment and economic growth, provided that external fiancial resources are likely to be sufficiently avaialble to underpin the exchange rate at such a level.

The various channels for its possible contributions in relieving external payments pressures suggest that devaluation can be a very helpful instrument of adjustment policy in all countries. Success with the instrument is, however,directly related to credible prospect for its nonrecurrent use in the foreseable future, underlining the critical importance of back-up financial discipline. In other words, as in the use of any major weapon, those most likely to use devaluation very effectively are those least likely to need it.

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