
Exchange Rate Policies in Developing and Post-Socialist Countries

Edited by Emil-Maria Claassen



International Center for Economic Growth



EXCHANGE RATE POLICIES IN DEVELOPING AND POST-SOCIALIST COUNTRIES

Edited by
Emil-Maria Claassen

An International Center for
Economic Growth Publication
ICS PRESS
San Francisco, California

©1991 International Center for Economic Growth

Printed in the United States of America. All rights reserved. No part of this book may be used or reproduced in any manner without written permission except in the case of brief quotations in critical articles and reviews.

Publication signifies that the Center believes a work to be a competent treatment worthy of public consideration. The findings, interpretations, and conclusions of a work are entirely those of the author and should not be attributed to ICEG, its affiliated organizations, its Board of Overseers, or organizations that support ICEG.

Inquiries, book orders, and catalog requests should be addressed to ICS Press, 243 Kearny Street, San Francisco, California, 94108. Telephone: (415) 981-5353; fax: (415) 986-4878. For book orders and catalog requests, call toll free in the contiguous United States: (800) 326-0263.

Cover design by M.R.P. Design.

Index by Shirley Kessel.

Distributed to the trade by National Book Network, Lanham, Maryland.

Library of Congress Cataloging-in-Publication Data

Exchange rate policies in developing and post-socialist countries
edited by Emil-Maria Claassen.

p. cm.

Proceedings of the Second Monetary Conference of the Freie Universität Berlin and the Landeszentralbank Berlin, held 05/10–12/90, at the Berliner Bank and sponsored by the International Center for Economic Growth.

"An International Center for Economic Growth publication."

Includes bibliographical references and index.

ISBN 1-55815-146-X (pbk.)

1. Foreign exchange—Congresses. 2. Monetary policy—Developing countries—Congresses. I. Claassen, Emil-Maria, 1934–
II. International Center for Economic Growth. III. Monetary Conference of the Freie Universität Berlin and the Landeszentralbank Berlin (2nd : 1990 : Berliner Bank)
HG3877.E93 1991
332.4'56—dc20

91-5029
CIP

EXCHANGE RATE POLICIES
IN DEVELOPING AND
POST-SOCIALIST COUNTRIES

PREFACE

Exchange Rate Policies in Developing and Post-Socialist Countries looks at one of the most important questions that all countries—both developing and developed—must answer: What is the optimal exchange rate regime?

Answering this question appropriately and following through with policy are now vital for economic progress in the developing and former socialist countries. Developing countries are coping with a history of import substitution, overvalued currencies, and hyperinflation. Meanwhile, the countries of Eastern Europe face a legacy of price controls, repressed inflation, and currencies that cannot be converted into goods. Both groups of countries are dealing with the effects of capital-intensive forms of production and rudimentary financial systems.

All of these problems are related to exchange rate policies. But reforming such policies is a large and difficult job. In what order should reforms be instituted? Should the exchange rate be fixed or managed? How can currency reform be made credible? And, for Germany, how can the monetary systems of two countries best be unified? Emil-Maria Claassen and the contributors to this volume—several of whom are helping the countries of Eastern Europe restructure their economies—bring their expertise and experience to bear on these hard questions.

This book presents the discussions that took place at a conference held May 10–12, 1990, in Berlin. The ideas presented in *Exchange Rate Policies in Developing and Post-Socialist Countries* will surely be useful for policy makers and economists playing a role in the changes still to come. We are pleased to have cosponsored the conference and to publish this important book.

Nicolás Ardito-Barletta
General Director

International Center for Economic Growth

November 1991
Panama City, Panama

xvii

ACKNOWLEDGMENTS

This volume is the outcome of the Second Monetary Conference of the Freie Universität Berlin and the Landeszentralbank Berlin, which took place May 10–12, 1990, at the Berliner Bank. The conference was made possible by the financial support of the following institutions (in alphabetical order):

Banca d'Italia (Rome)
Berliner Bank (Berlin)
Commerzbank (Berlin)
Deutsche Bank (Berlin)
Deutsche Stiftung für Internationale Entwicklung (Berlin)
Dresdner Bank (Berlin)
Flick Stiftung (Düsseldorf)
Freie Universität Berlin
International Center for Economic Growth
(Panama City and San Francisco)
Landeszentralbank Berlin
Repap Enterprises Inc. (Montreal)
Senat der Stadt Berlin
Sparkasse der Stadt Berlin

My special thanks are addressed to these donors and to all the institutions of Berlin.

Emil-Maria Claassen

CONTENTS

	<i>List of Tables</i>	ix
	<i>List of Figures</i>	xiii
	<i>Preface</i>	xvii
	<i>Acknowledgments</i>	xix
Part I Introduction		
Chapter 1	Exchange Rate Policies in Developing and Post-Socialist Countries: An Overview <i>Emil-Maria Claassen</i>	3
Chapter 2	Stabilization Policies in Developing and Socialist Countries <i>Robert A. Mundell</i> Comments: <i>Juergen B. Donges</i>	21
Part II Socialist Countries		
Chapter 3	Stabilizing the Ruble: The Problem of Internal Currency Convertibility <i>Ronald I. McKinnon</i>	59
Chapter 4	Stabilization Policies in Poland: A Progress Report <i>Roman Frydman, Stanislaw Wellisz, and Grzegorz W. Kolodko</i> Comments: <i>Edmund S. Phelps</i>	89

Chapter 5	Gradual or Radical Transformation? The Case of the German Monetary Union <i>Emil-Maria Claassen</i> Comments: <i>Dieter Bender and Daniel Gros</i>	123
Chapter 6	The Eastern Bloc: Legal Reforms before Monetary and Macroeconomic Policies <i>Ruven Brenner</i> Comments: <i>John Williamson</i>	151
Chapter 7	Intraregional Convertibility in Eastern Europe: Is It Still an Issue? <i>Marie Lavigne</i>	175
Part III	Developing Countries	
Chapter 8	Exchange Rate Policies in Developing Countries <i>Bijan B. Aghevoli and Peter J. Montiel</i> Comments: <i>J. Peter Neary</i>	205
Chapter 9	Capital and Current Account Liberalization and Real Exchange Rates in Developing Countries <i>Sebastian Edwards</i>	243
Chapter 10	Growth Collapses, Real Exchange Rate Misalignments, and Exchange Rate Policy in Developing Countries <i>Deepak Lal</i> Comments: <i>Apostolos Condos</i>	277
Chapter 11	Exchange Rate Policy in Countries with Hyperinflation: The Case of Argentina <i>Roque B. Fernández</i> Comments: <i>Juan L. Cariaga</i>	305
Chapter 12	Unification of Official and Black Market Exchange Rates in Sub-Saharan Africa <i>Brian Pinto</i> Comments: <i>Friedrich L. Sell</i>	327
Chapter 13	Exchange Rate Policies for the East Asian Newly Industrialized Countries <i>Yung Chul Park and Won-Am Park</i> Comments: <i>Helmut Reisen</i>	357

Part IV	Conclusion	
Chapter 14	Advice on the Choice of an Exchange Rate Policy <i>John Williamson</i> Comments: <i>Herbert G. Grubel</i>	395
	<i>References</i>	409
	<i>About the Contributors</i>	425
	<i>Conference Participants</i>	431
	<i>Index</i>	433

LIST OF TABLES

Table 3.1	Financial Statistics for the Soviet Economy, 1979–1989	60
Table 3.2	Soviet Government Expenditure and Revenue, 1980–1989	62
Table 3.3	Government Revenue in the People's Republic of China, 1978–1988	63
Table 3.4	Alternative Domestic Financial Arrangements for Enterprises in Transition	79
Table 4.1	Fiscal Budget Balance in Poland, January 1989–March 1990	94
Table 4.2	Retail Prices in Poland, January 1989–April 1990	97
Table 4.3	Monthly Interest Rates in Poland, January–April 1990	102
Table 4.4	Indexation and Nominal Wage Increases in Poland, January–April 1990	104
Table 4.5	Sales and Net Profits of Poland's Socialized Sector, January 1989–March 1990	108
Table 4.6	Employment in Poland's Socialized Sector, January 1989–March 1990	108

Table 4.7	Unemployment in Poland, January–April 1990	109
Table 5.1	Quantity of Money of the Federal Republic of Germany (FRG) and Estimated Demand for Money by the German Democratic Republic (GDR), Mid-1990	129
Table 8.1	Exchange Rate Arrangements of Developing Countries, 1976–1989	208
Table 8.2	Geographical Distribution of Exchange Rate Arrangements for Developing Countries, 1983–1989	211
Table 8.3	Trend Movements of Relative Prices, Nominal and Real Effective Exchange Rates, and Terms of Trade for Different Regions, 1978–1989	214
Table 8.4	Trend Movements of Relative Prices, Nominal and Real Effective Exchange Rates, and Terms of Trade for Groups of Countries, According to Their Exchange Rate Arrangements, 1982–1989	220
Table 9.1	Real Exchange Rate Determination in Developing Countries	257
Table 9.2	Notation Used in the Model of Equilibrium Real Exchange Rates	271
Table 10.1	Growth Instability in Twenty-one Developing Countries, 1950–1985	278
Table 10.2	External Shocks and Adjustment in Thirteen Developing Countries, 1974–1981	283
Table 10.3	Developing Countries with Chronic or Acute Inflation or Growth Collapse, 1964–1985	285
Table 10.4	Changes in Ratio of Public Debt to GDP in Countries with Chronic or Acute Inflation, 1965–1986	287

Table 10.5	Factor Intensities and Price and Wage Rate Movements in Twenty Developing Countries, 1973–1986	295
Table 12.1	Inflation, Seigniorage, and Tax on Exports through the Black Market Premium in Ghana, 1970–1983	340
Table 12.2	Deficit Finance, Inflation, and the Black Market Premium in Nigeria, 1980–1985	343
Table 12.3	Fiscal Deficits, Monetary Base, and Inflation in Sierra Leone, June 1986–January 1987	346
Table 13.1	Exchange Rate Arrangements of Developing Countries in the Asian Pacific Region as of December 31, 1982, 1985, and 1989	361
Table 13.2	Changes in Nominal and Real Exchange Rates, 1981–1989	367
Table 13.3	Economic Developments in Taiwan and Korea, 1981–1989	368
Table 13.4	Economic Characteristics of the East Asian NICs, 1980–1988	385

LIST OF FIGURES

Figure 2.1	The Anatomy of Disequilibrium	26
Figure 2.2	Repressed Inflation	29
Figure 2.3	Open Inflation	30
Figure 2.4	Equilibrium under Fixed Exchange Rates	32
Figure 2.5	Real Wage Adjustment	33
Figure 2.6	Draining the Overhang	35
Figure 2.7	Undervalued Labor	37
Figure 2.8	Overvalued Labor	39
Figure 3.1	Soviet and U.S. Inventories as a Percentage of National Income, 1960–1985	70
Figure 4.1	Monthly Price Indexes of Foodstuffs in Poland, January 1989–April 1990	95
Figure 4.2	Monthly Expenditure for Foodstuffs by Households in Poland, January 1989–April 1990	95
Figure 4.3	Monthly Retail Prices and Wage Indexes in Poland, January 1989–April 1990	96

Figure 4.4	Index of Real Wages in Poland's Socialized Sector, January 1989–April 1990	96
Figure 4.5	Real Free-Market and Official Rates of Exchange in Poland, January 1989–April 1990	98
Figure 4.6	Nominal Free-Market and Official Rates of Exchange in Poland, January 1989–April 1990	99
Figure 4.7	Weekly Rate of Inflation of Consumer Goods and Services in Poland, January–April 1990	105
Figure 4.8	Monthly Rate of Inflation in Poland, January–April 1990	106
Figure 4.9	Index of Output Sold in Poland's Socialized Sector, January 1989–April 1990	107
Figure 4.10	Index of Employment in Poland's Socialized Sector, January 1989–April 1990	109
Figure 5.1	Exchange Rates of East and West Germany, 1948–1990	128
Figure 5.2	Migration from East to West Germany, 1974–1990	132
Figure 5.3	Model for Migration from East to West Germany	134
Figure 5.4	East Germany's Monetary Overhang	136
Figure 5.5	East Germany's Total Disequilibrium for Goods and Money Markets	140
Figure 8.1	Industrial and Developing Countries: Movements of Real and Nominal Effective Exchange Rates and Relative Prices, 1978–1989	215
Figure 8.2	Regions of the World: Movements of Real and Nominal Effective Exchange Rates and Relative Prices, 1978–1989	216

Figure 8.3	Movements of Real and Nominal Effective Exchange Rates and Relative Prices for Countries with Pegged, Managed, or Crawling Peg Exchange Rates, 1978–1989	222
Figure 9.1	Initial Equilibrium in the Economy	247
Figure 9.2	Effect of Liberalization of the Capital Account on Equilibrium Real Exchange Rates	249
Figure 9.3	Effect of a Temporary Reduction in Import Tariffs on Equilibrium Real Exchange Rates	250
Figure 10.1	Three-Good Model of an Open Economy	288
Figure 10.2	Three-Good Model of Prices, Wage Rates, and Rental Rates	292
Figure 11.1	Nondollar Share of the Argentine Government Debt, November 1986–December 1989	314
Figure 11.2	Relationships of the Real Interest Rate and the Devaluation Rate	316
Figure 12.1	Dynamics of the Exchange Rate and Fiscal Policies	336
Figure 13.1	Nominal and Real Effective Exchange Rates in Japan, the United States, and West Germany, 1980–1989	363
Figure 13.2	Real Effective Exchange Rates in the East Asian NICs and Members of ASEAN, 1981–1989	365
Figure 13.3	Consumer Price Inflation Rates in the East Asian NICs and Members of ASEAN, 1980–1988	374
Figure 13.4	Growth Rate of M2 in the East Asian NICs and Members of ASEAN, 1980–1988	375
Figure 13.5	Impact of Currency Appreciation on Capital Accumulation	380

Figure 13.6	Impact of Currency Appreciation on the Real Exchange Rate and the Price of Real Estate	382
Figure 13.7	Index of Real Effective Exchange Rates for Japan and the East Asian NICs, 1985–1990	384
Figure 13.8	Deviations from Purchasing Power Parity (PPP) in Germany, 1953–1979, and in Korea, 1968–1987	387
Figure 13.9	Index of Productivity Growth in Manufacturing in Japan and Korea, 1970–1988	390

PART ONE

INTRODUCTION