1 The Issues

The Problems of Devaluation

During the spring and early summer of 1983 the Philippine economy faced formidable problems: economic growth had slowed, inflation had accelerated, and the deficit in traded goods and services for the first quarter of the year ($343 million) was more than twice the rate forecast by the Philippine government. On June 23, 1983, the Philippine Central Bank officially devalued the peso by 7.3 percent. In a letter to President Marcos, Jaime Laya, head of the Central Bank, said the new exchange rate "reflected the true international value of the peso" and would have "positive effects on the balance of payments," making Philippine exports relatively cheaper and imports more expensive.[1]

By the fall of 1983 the Philippine economic situation had deteriorated further. At the end of the third quarter the trade deficit had surged to $1.36 billion, the August assassination of Benigno Aquino had affected the political stability of the Marcos regime, and the Philippines faced a major problem with capital flight.[2] Although the Philippines had long been plagued by an inefficient industrial sector and its dependence on imported fuel, the crescendo of economic problems in 1983 seemed ominous.[3]

At the time of the June devaluation the Philippine government reached an agreement with the International Monetary Fund (IMF) to receive a $345 million standby credit, but this was conditioned on taking measures to slow inflation, restrict domestic credit, and contract the current account deficit. Yet as the economic news turned from bad to worse, the Philippine government was torn between possible courses of action. Should it undergo the rigors of an even larger devaluation? Impose domestic price controls? Tighten controls on capital movements? Dismiss sizable numbers of government workers? Or end subsidies to industrial firms? All of the options were unappealing. By October 5, 1983, the government decided against direct controls but tightened overall monetary and fiscal austerity measures, made a commitment to the IMF that the 1984 trade deficit would be below $1 billion, and announced a second devaluation, this one totaling 21.4 percent.

In 1976 the Peruvian government of General Morales Bermudez had faced a situation similar to the Philippine crisis of 1983. Peruvian economic growth had been rapid in the 1968–1973 period, but by the mid-1970s Peru was mired in seemingly intractable problems. Copper prices were down; expenditures for oil exploration had not been as successful as predicted; the usually abundant anchovy schools had vanished, reducing fishmeal exports; and President Morales found his government obligated to pay nearly $900 million per year in debt service and amortization on the $4 billion borrowed by his predecessor's government. The predicament was compounded by large deficits in public sector enterprises, a decline in the domestic savings rate, and an increase in inflation from 14 percent in 1973 to over 50 percent in 1976.[4] The Peruvian government began negotiations with the IMF in 1976 about receiving a standby credit but could not reach agreement on the character and extent of the stabilization program to be put into effect.

The Morales government then tried a novel tack: it did an end run on the IMF. The Peruvian Central Bank began discussions with a consortium of private commercial banks that ultimately agreed to provide a loan package of $398 million in the fall of 1976. The conditions were stringent, however. The Peruvian sol was to be devalued immediately by 31 percent and afterward by regular monthly "crawling-peg adjustments"; public sector wages were to be frozen for eighteen months; phased budget cuts were announced; and subsidies on key consumer items were to be reduced, thus necessitating nationwide price increases.[5]

Although the initial response by the Peruvian public was muted, by February 1977 the Morales government had begun violating the terms of the loan agreement in response to pressure from particular interest groups. The military received a special pay increase, the budget was expanded rather than curtailed, and subsidies were ended only on selected consumer goods. The banks thus suspended their loans in March, and the government faced a major impasse. Its trade deficit was swelling to a rate of over $1 billion per year, financing was not available for new imports, and the public was restless. On July 19, 1977, there was a twenty-four-hour general strike in Lima, and in a series of clashes between demonstrators and troops, thirteen people died. In the same month the civilian economics minister and the governor of the central bank resigned when the cabinet (which was dominated by the military) refused to accept the terms that the IMF was insisting on as a precondition for new credit.

After months of rancorous negotiations, with the Peruvian government threatening to default on its private debt obligations and the IMF stoutly refusing to offer new funds, an agreement was reached on a new standby credit in November 1977. Within a month the Morales government had violated the terms of the agreement, and the IMF suspended its credit. Not until July 1978 was a lasting arrangement worked out with the IMF. It entailed major cuts in government spending, tax increases, an end to subsidization of interest rates at government banks, and a commitment to periodic, further devaluations of the sol.[6]

Both the Philippine and Peruvian governments chose to postpone currency devaluations as long as possible. Both saw the devaluations and related stabilization programs as a major setback, and both saw the conditions imposed for receiving the IMF standby credit as a capitulation to foreign powers.

Why did these governments try to avoid devaluation for so long? Was it because of the resulting increase in prices for imported goods? The likely shifts in income to exporters and away from consumers of imports? The perceived loss of sovereignty involved in making a commitment to the IMF about internal economic policies? Or was the recalcitrance even more fundamental, with both governments resisting the IMF's urgings to trim government expenditures, reduce controls on trade, and end various subsidies? Why does devaluation still produce such wrenching changes when many economists had predicted that the introduction of the flexible exchange rate system in the post-1971 period would make parity changes a smooth and continuous process?

The blunt answer is that devaluation frequently involves a blend of all the problems raised in the questions. It is rare that a government has the good fortune to deal with these issues one at a time. In addition to economic problems, national leaders must be highly sensitive to the political implications of their economic policy choices. It is worth noting that, despite the fact that the Marcos government is a rightist authoritarian regime and the Morales government was of leftist authoritarian stripe, both feared proceeding with devaluation, and both lost popularity when the exchange rate changes were announced. We can thus be confident that regimes across a broad ideological spectrum have similar concerns about the impact of a devaluation.

Purpose of this Book

Given the dramatic increases in less developed country (LDC) borrowing in the past decade and the subsequent debt servicing problems, the growing complexity of planning and implementing a devaluation, and the likelihood that these difficulties will continue, there is a need for a systematic examination of currency devaluation as a policy problem. Although there is a vast literature on the theoretical aspects of devaluation, this book concentrates on the practical problems that policymakers face in planning and implementing a devaluation. Three central questions are posed in this study:

1. What drives a country to devalue?
2. What determines the likely success of a devaluation?
3. What are the critical stages in a devaluation process?

To respond to these questions, we will examine detailed case studies of devaluations in India, Indonesia and Ghana. Not only are these cases historically significant, but their diversity illustrates the range of problems and constraints facing a government considering devaluation. Also, in each of these cases, the governments were being pressured to devalue, and this added a special element of complexity to the decision process.

Because devaluation is a frequent, critical, and often volatile issue for LDCs, it merits particular attention.[7] Most LDC governments do not have enough foreign exchange and the financial expertise to manage a float of their currencies.[8] They choose instead to peg their currencies in a fixed ratio to one of the major reserve currencies: the U.S. dollar, French franc, British pound, or the IMF's special drawing right (SDR). In June 1984 ninety-three of the world's governments had pegged their currencies, and only four (Canada, Japan, the United Kingdom, and the United States) met the IMF's criteria for fully "independent floating."[9]

Although the current international financial arrangements are called the floating exchange rate system, virtually all of the LDC governments face a somewhat mixed situation where their parities are officially fixed (in relation to one of the reserve currencies) but do move up and down as the price of the reserve currency fluctuates.

This means that LDC governments must be ready to make two types of adjustments: (1) adapting to the daily oscillations of the currency to which they have pegged and (2) making less frequent but more fundamental shifts when they change the ratio between their currency and the reserve currency. Each time there are parity changes relative to either the major currency or the rest of the world, there are internal price changes that affect economic performance. Although the floating exchange rate system was designed to ease economic adjustment and has done so to some extent for the Western industrial democracies, in important ways it has complicated the situation for LDCs.[10]

Devaluation is a policy decision of extraordinary power. Unlike expenditure programs that require staff to implement or tax programs that the public can often avoid, a devaluation can be planned by a small group and has pervasive effects on an economy. Devaluation usually has an immediate impact on traded goods, often followed by subsequent effects on a nation's price, employment, and growth performance. Yet because a government wants to avoid a speculative attack on its currency, the preparations for a parity change are usually made by a limited number of trusted technical staff.[11] If a researcher has access to members of the staff or their records, it becomes a manageable project to reconstruct the main events and influences on the decision.

Devaluation is also of interest from a political-economy perspective because it has national prestige implications with which few other economic policies are burdened, making it an interesting case of economic efficiency versus political prestige concerns for a government.

Devaluation is a curious remedy; the costs (increased import prices, shifts in employment, and possibly inflation) come at least twelve to eighteen months before the benefits (expanded exports and employment). This makes political leaders want to get it over with, blame it on the previous administration, and find some way to blunt criticism of the decision without trying to explain the technical details to an uncomprehending public. Attempts by French President Mitterand to blame the United States for the franc devaluations in 1982 and 1983 (despite the fact that France's inflation rate was twice the U.S. rate) is a good example of this approach.

A parity change has in addition differential effects on diverse groups of people. A devaluation rewards producers in the import-substituting and export sectors and penalizes consumers or producers who use imported goods. This has significant class implications in most LDCs where middle- and upper-income groups are the main importers.[12] It also has important consequences for urban versus rural divisions because agricultural and raw material exports are often the first to benefit from a devaluation, while urban service sector consumers feel an immediate pinch. If urban consumers are unionized or politically powerful, reducing their incomes is a risky exercise.

Most important, devaluation warrants attention because LDCs have even less success than the developed countries in controlling inflation, and they repeatedly need to adjust their parities to keep exports competitive and avoid encouraging imports. So not only will the LDCs have the problem of dealing with the fluctuating exchange rate system,[13] but their difficulties in coping with internal interest groups and inflationary pressures are likely to make devaluation a continuing policy dilemma.[14] Although there has been sentiment in the United States and Europe for a return to fixed exchange rates, the advocates of this step appear to have only limited support among the major member countries in the IMF.

The Central Hypotheses and a Framework for Analysis

Among academic economists, there have been three principal approaches to analyzing devaluation. The *elasticities approach* has concentrated on evaluating the effects of parity changes on the balance of trade. Using partial equilibrium methods and assuming that all other factors are constant, advocates of this approach have shown that a devaluation will improve a country's balance of trade if the sum of the elasticities of demand for its exports and imports is greater than one.[15] Further refinements of this view have shown the conditions necessary for a country to improve its balance of trade if it starts from a position of trade deficit.[16] The advantage of this approach is that import and export supply and demand elasticities are measurable, and the analysis focuses on the odds that the trade balance will actually improve. The limitations, however, are that all other factors are rarely constant, and it does not provide a policy guide of how to handle the situation if other dilemmas (like inflation or resistance from key interest groups) are plaguing a government.

The *absorption approach* grows out of the Keynesian tradition, emphasizing that there is a fixed supply of goods and services in an economy at full employment. Under these conditions devaluation can be successful only if the domestic absorption of goods is reduced to permit either fewer imports or increased exports.[17] The absorption approach has also been used to show that instead of stimulating demand, devaluations can actually be deflationary if the resulting relative price changes favor groups in the society with low propensities to consume.[18]

The *monetary balance approach* draws on elements of both other schools but introduces two additional refinements by showing how asset balances of citizens are affected and how capital flows in and out of the devaluing country shape the balance of payments position.[19] Monetary balances are important because devaluation lowers the value of assets for holders of domestic currency. This may lead to increased savings to recoup the lost assets, a process that can be deflationary if there is a sizable decrease in consumption. Also if there is fear that devaluation may be a recurring phenomenon (clearly the case in many developing countries), the public may try to hold its assets in foreign currency or foreign bank accounts.

The monetary balance approach raises an even more troubling problem. There is evidence that it takes long periods (six to eighteen months) for producers to shift orientation and for trade balances to adjust, but with the increasing sophistication of world capital markets, financial adjustments may take place within a matter of days.[20] This means not only that capital adjustments may work in opposition to the desired trade adjustments but that there could be numerous shifts (positive or negative) in the monetary balance effects during the period when a country was trying to implement an overall program to improve its trade balance.

In sum, economists have developed a set of useful quantitative methods for identifying the constraints policymakers face when considering a devaluation. Nevertheless the effects of a devaluation depend on the circumstances under which it takes place. If the devaluing country had been at full employment and close to balance of payments equilibrium and the parity change was designed primarily to cope with a new external shock (like the oil price increases of 1973–1974 and 1978–1979), the necessary internal adjustments, though possibly large in magnitude, can be directed toward the principal goal of increasing exports and slowing imports.

As noted in the Philippine and Peruvian cases, however, many developing countries are using devaluation as part of a more complex policy package to address internal and external problems. A common situation is for the country to be facing simultaneously an internal budget deficit, inflation, a deteriorating balance of payments position, and difficulty in meeting foreign debt obligations. Under these circumstances, currency devaluation is only one of many steps that need to be taken to stabilize the economy.

Although devaluation is a frequent and often traumatic occurrence in LDCs, it has not been the subject of much commentary in the political science literature. Between 1980 and 1984 not a single article appeared in the *American Political Science Review* examining this key policy problem for LDCs.

There is relevant work in the political economy literature that analyzes the context in which LDC governments make economic policy choices. One key theme is how the character and extent of trade affect national power and bargaining.[21] There is also extensive work on how economic dependence shapes decision making.[22] There is a growing literature on how a country's national interest may be compromised or enhanced through political pressure.[23] And some recent theoretical work examines the asymmetrical relationships that typify bargaining on international economic policy questions.[24]

This book attempts to combine analysis of both the political and economic aspects of devaluation. The following five hypotheses are designed to provide a comprehensive but integrated description of the political and economic constraints that LDC policymakers face when deciding whether to proceed with devaluations:

1. The success of a devaluation requires both short- and long-run adjustments. In the short run a devaluation is successful when the respective price and income elasticities for exports and imports facilitate a marked improvement in the balance of trade, the macroeffects of the parity change supplement the government's overall policy package, there are no destabilizing capital flows, and the moves are accepted as legitimate by the public.

2. In the long run a devaluation is successful if there are fundamental shifts in resources toward export development and a slowing of the rate of growth of imports, if inflation moderates, and if the reallocation of income (toward exporters and import substituters) is not reversed through political pressure or other means.

3. A devaluation's success in economic terms is in many cases incompatible with the political constraints facing the regime in power. The devaluing government needs maneuverability to deal with the reductions in real income and reallocation of resources that occur. Maneuverability requires some tangible hope that the devaluation will lead to an improvement in the balance of payments, usually entails domestic credit constraints, and frequently necessitates external aid or credit.

4. The actual monetary and fiscal effects directly attributable to a devaluation are often thwarted by adverse foreign macroeconomic conditions or other internal economic problems that limit resource reallocation within the devaluing country.

5. Devaluations produce such complex changes that economists are frequently unable to identify and estimate the full extent of the subsidiary effects. Political decision makers are at an even greater disadvantage because they typically have little familiarity with the details of a parity change. Devaluation has the additional disadvantage that the costs to the public are immediate, while the benefits frequently take eighteen months to be felt.

Given the complexity of devaluation, the range of circumstances that precipitate it, and the differing limitations each country faces following a parity change, an elaborate quantitative effort would be required to develop a fully satisfactory model for devaluation episodes. Without initiating a vast modeling exercise, however, it is possible to identify the major groups likely to benefit or suffer from a devaluation. Additionally it is useful to distinguish the initial political and economic effects of a devaluation from the longer-run changes that occur as the rewards and disincentives of the exchange rate change work their way through the economic system. Since so many devaluations are part of an overall stabilization program, it is also worthwhile to separate the effects of stabilization measures from those of the devaluation. Table 1.1 presents the results in a simplified, schematic form.

The Questions to Be Addressed

In approaching these devaluation decisions, we will want to explain their differences, but it is also useful to organize the discussion around several key theoretical questions. Not only do we want to know why a country devalues but what systematic patterns there are in predicting the outcomes and what analytic structure to use for approaching the disparate information available about a devaluation episode.

1. *What drives a country to devalue?* Governments choose devaluation under basically three types of circumstances: under duress, when there are attractive inducements, and when the devaluation is part of an overall program that requires a parity change to be effective.

Necessity is probably the principal driving force behind most devaluations. When governments find that they are exhausting their foreign exchange and are unable to obtain additional funds from foreign creditors, they ascertain that the situation is serious. Yet there are a host of interim remedies: increased tariffs, quotas, selective credit policies, licensing requirements, and contractionary domestic macroeconomic policy.

What frequently tips the balance in favor of devaluation is the recognition that these interim steps have not worked or will not work sufficiently quickly to avoid a crisis. The Ghanaian devaluation of 1971 is a classic example of this type. The Ghanaian government was unable to meet its payments obligations and had run out of feasible alternative measures. Although few regimes wait as long before acting as the Busia government did, the threat of having to cut off new imports or default on payments is a powerful stimulant. In approaching other devaluations, some of the initial

Table 1.1
Likely effects of a devaluation in an LDC

	Groups hurt	Groups helped
Direct effects of devaluation		
Economic		
Relative price changes and resulting income effects	Consumers using imports	Exporters
	Producers requiring imported raw materials or intermediate goods	Producers of import substitutes
	Urban, middle, and upper classes relying on imported consumables, durables	Producers of nontradables (construction, local services)
Asset effects	Holders of domestic currency	Holders of foreign currency
Political		
Criticism for bad economic performance	Government in power	Opposition
Concentration of responses	Volatile, articulate urban dwellers	Rural inhabitants and those in export industries
Secondary effects of devaluation		
Inflation	Wage and salary earners unable to keep pace with inflation	Debtors
	Savers	Holders of real assets
	Holders of money and nonindexed financial assets	
Possible recession	Most wage-earning workers	Exporters due to greater price competitiveness
	Most producers for domestic consumption and investors in domestic industry	
Emphasis on exporting through relative price changes and shifts in government programs	Importers	Exporters
	Domestic sectors receiving less government support	

Table 1.1 (continued)

	Groups hurt	Groups helped
Related consequences if devaluation is part of a broader stabilization program		
Restrictive credit policies	Leveraged investors and those relying on low interest and government credit	Those trying to compete with government firms or government-subsidized firms
Price rather than quantitative restrictions on trade	Domestic industries less protected by quotas and by government's former determination of resource allocation	Efficient producers who were limited when government was allocating foreign exchange
Restrictive government budget policy	Any area of direct funding or subsidies that were cut due to general attempts to reduce domestic budget deficits	Private sector to the extent that resources are freed for nongovernmental uses

questions to ask are thus: How severe was the crisis? What would have happened had the government delayed?

Attractive inducements can also encourage national leaders to take steps that they know will be painful. In the Indian devaluation of 1966, Prime Minister Indira Gandhi certainly understood that there would be strong opposition to devaluing the rupee, yet the World Bank and bilateral aid donors were offering such an enticing package of new aid that the benefits appeared to outweigh the costs.

Inducements need not always be external resources. If a devaluation is likely to produce a substantially more efficient internal combination of production and investment, then it may well warrant the dislocations involved. Naturally different governments will evaluate the risks involved in varying fashions, but the analyst must look for patterns in how the costs and benefits were assessed.

Devaluations are increasingly being recommended as elements of overall programs for adjustment. The Indonesian devaluation of 1970 is an interesting example of this motivation for a parity change. President Suharto's economic advisers had long planned to end their dual exchange rate system, simplify export taxation, and consolidate administration into a single, market-determined exchange rate. When the IMF offered its standby agreement, the devaluation and rate consolidation became an attractive prospect.[25]

With the World Bank now offering structural adjustment loans and the IMF vigorously pursuing its enlarged access policy, LDC governments may prefer to wrap devaluations into an even broader set of policy changes. It may also be easier for a government to justify a devaluation if it is viewed as one element in an effort to adjust to higher energy prices and generate enough foreign exchange to service debt. We will thus want to identify those aspects of a devaluation that can augment or impede adjustment programs.

2. *What determines the likely success of a devaluation?* No single variable can be used to predict the success of a devaluation. Ultimately national leaders choose devaluation when they are severely constrained, and they look for flexibility in policy options. Success is a relative term. At a minimum it can mean avoiding a disastrous cutoff in imports; moderate results might entail some internal reallocation of resources and improvement in the balance of trade; and a resounding success could mean major changes in internal production and investment behavior, and the development of a dynamic export sector.

Most of the literature on devaluation has focused on the economic issues. This book attempts to set out the process in a broader context. The basic argument will be that the success of a devaluation depends on the maneuverability open to the government concerned. The freedom to maneuver is a complex blend of three factors: latitude in the economic variables, the extent of domestic political constraints, and the character and extent of international support. It may not be possible, in advance of a devaluation, to know which of these clusters of variables is most important, but they are clearly interdependent and a government must deal adequately with each area to achieve fundamental changes.

The economic factors shaping the success of a devaluation are the easiest to measure. One tangible measure is whether the devaluation improves the balance of trade. This, however, is not an adequate overall judgment on the effectiveness of a parity change. It has even been suggested that a devaluation is a success if the country's minister of finance survives in office at least twelve months after the decision.[26]

Yet there are clearly a range of economic variables that need to be assessed: how large are the foreign exchange reserves, and how long can the country wait for export earnings to improve? What are the elasticities of demand for those export products that the country can plausibly produce? How innovative and effective are the country's entrepreneurs? For agricultural goods, how predictable is the country's climate, and how easily can resources be moved into higher-productivity crops and processing? How critical are timing considerations? Are there elections, potential military conflicts, holiday seasons, or crop cycles that will make a government want to speed up or delay a decision? None of these factors alone will prevent a country from devaluing if it faces a severe crisis; nevertheless, a prudent policymaker will probe each of these issues to determine likely performance.

The most comprehensive presentation of how economic variables will affect the likely success of a devaluation is available in the series edited by Jagdish Bhagwati and Anne Krueger.[27] They and their coauthors explore the most propitious circumstances to enable an LDC to remove internal controls and reallocate resources. They show that a devaluation can be part of a building process where early success at removing the trade deficit provides resources necessary for the further removal of protection. Thus maneuverability provides promise of acceptable performance on certain key variables and creates the right sequence of steps.

The domestic political constraints are frequently given inadequate attention when devaluations are planned, yet both the Ghanaian and Indian governments ultimately failed because they encountered intense domestic resistance. Here the analyst also needs to look at a range of issues: Which businessmen are in the export trade? What are the links between business and government? How extensive is the level of protection? Which sectors are receiving subsidies? Would particular regions of the country or classes noticeably gain or lose through a parity change? Is there a religious or cultural reason why greater reliance on competition will be resented? It is not possible to quantify these variables with precision, but they are vital for determining outcomes and need to be put on a par with the economic factors in determining a national leader's room to maneuver.

National political leaders must also be concerned with how the devaluation is perceived by their citizens. If balance of payments problems are brought about by a war or by some external event the government could not control, the public may be willing to support the government despite the deprivations. Yet if the devaluation is seen as a result of economic mismanagement or as part of an overall program to shift rewards permanently in the society, the resistance can be intense.

In the Ghanaian case the devaluation of the cedi clearly helped rural, small-holder cocoa growers and hurt unionized labor, civil servants, and the military. Although Ghana was a democracy at the time and low-income cocoa farmers vastly outnumbered the urban elites, the Ghanaian political system was sufficiently fragile that it could not take the strain of such major income redistribution. There are also dynamic elements that need to be considered. If the exchange rate change is one bit of bad news for a regime generally perceived as competent, public acceptance is vastly different than in a situation of extended miasma. Since most LDC governments are not democracies, one also needs to evaluate how effective the means of coercion are if serious resistance develops.

The international environment is often viewed in exclusively economic terms: what are the export and import supply and demand elasticities, and what type and volume of credit is available? In a pre–World War II environment, this might have been a realistic way to look at devaluation. But currently a country must estimate not only what resources will be available from bilateral donors and multilateral agencies but whether these organizations will play an attentive and supportive role in encouraging further private sector participation.

Here several sensitive issues come into play: the strategic significance of the country to potential donors, the size of its internal market, the experience of the donors and multilateral agencies when they were involved in past attempts at giving policy advice, and whether the country has either critical resources or a sufficiently large debt that it could threaten other nations by its behavior. Given the high visibility of these external funding sources, few heads of government spurn them, but in each of the three case studies we will note how the outside organizations were able to shape outcomes.

In sum, an adept national leader will assess constraints and then attempt to maximize maneuverability given the economic variables, domestic political structure, and international scene.

3. *What are the critical stages in a devaluation episode?* In dealing with the range of pressures and actors involved in a devaluation, it is useful first to analyze the setting in which the decision takes place and then to focus on the actual stages of the process.

For our purposes, it is worthwhile to divide devaluations into two broad categories: those where the country is basically operating on its own, with minimal outside interference, and those where foreign advice and offers of foreign resources play a significant role in the decision process.

In the situation where the devaluing country is operating independently (either because it does not want or is unable to obtain substantial foreign advice or resources), the calculus is simplified. The aspects of the external environment that are important are predominantly economic—in particular, the relevant supply and demand elasticities and estimates of how quickly the balance of trade will change. If external resources are not available to cushion the effects of the devaluation, the adjustment may be wrenching. Thus a government in this situation needs to plan for resistance to its decision and design an overall policy package that works with limited resources and protects those most vulnerable to the parity change.

Most LDCs, however, do not operate independently. They are typically members of the IMF and World Bank, and most have some access to private credit. Therefore this group will receive most of our attention. When foreign involvement is important, the external environment is vastly more complicated. The government concerned must not only calculate the pure economic effects of a devaluation but must decide on the best negotiating strategy for obtaining the foreign resources.

There is a fundamental asymmetry between the foreign organizations and the country considering devaluation. Each side knows that the foreigners can simply withdraw funds if they so choose. Hence to sustain a relationship for months or years, there needs to be a mutually satisfactory set of guidelines for their interaction. Obviously there is considerable variety in these relationships. Typically, large numbers of individuals are involved, and they frequently have conflicting goals and operating styles. The essential element, however, is the judgment by each of the foreign organizations and the devaluing country of how significant their interaction will be. Thus we have a classic bargaining situation.[28]

The bilateral donors are commonly concerned with the location, strategic significance, volume of trade, key natural resources, level of foreign investment, commercial borrowing, and political orientation of the recipient. The international organizations, such as the World Bank and the IMF, have only an oblique interest in the military status of their clients, but the magnitude of trade and debt and political prominence strongly influence how responsive they will be.

The devaluing country must choose its patrons carefully. A government receiving outside assistance must judge whether outside resources are adequate to compensate for the costs. The costs will vary among countries, but they often entail reduced policy flexibility and create a situation in which the government can be criticized. In sum, as a country's foreign exchange reserves dwindle and balance of payments difficulties appear imminent, the donors and the potential recipient rate their respective partners. If a mutually satisfactory relationship appears feasible, the delicate art of shaping an explicit understanding commences.

Each devaluation episode is distinct. Yet certain common patterns of behavior allow us to categorize the interaction between the parties. This interaction could be measured by several indexes: volume of resource flow, publicity given to the agreements, or number of people directly or indirectly affected by the decision. Although we will look at these measures in the case studies, none is fully effective at capturing the character of relations between the foreigners and the devaluing country.

The most tangible indication of how seriously the parties take the relationship is the rank of the individuals involved. For example, in the Polish debt rescheduling and negotiations of 1981, prime ministers and presidents were directly involved. In contrast, the Turkish devaluation and debt rescheduling undertaken during 1979 and 1980 was handled predominantly by senior technocrats and private bankers. High visibility is not always a benefit, but the rank of those involved is a critical indication of what the participants expect.

Stages in a Devaluation Episode

One way to approach a devaluation is to follow the sequence of economic policy measures chosen (moves back and forth between tightness and looseness in exchange controls, quotas and tariffs, and parity adjustments).[29] Another way would be to do two cross-sections, comparing before and after for the gamut of micropolicies and macropolicies selected.[30] Each of these approaches has merit, depending on the aspects of the episode of greatest interest. Here, however, the focus will be on the decision-making process.

In the India, Indonesia, and Ghana cases, there were four essential stages common to each episode:

Stage 1: the establishment of an *arena* where the devaluing country and the foreign organizations determine the seriousness of their interaction and the character of foreign involvement in the decision

Stage 2: the *bureaucratic politics* where competing policy options are presented, and different factions maneuver to have their views incorporated into the devaluation package

Stage 3: the actual *executive decisions* where the president or prime minister determines the scope of the devaluation adjustment program

Stage 4: the *implementation* process, including the timing, the manner of presenting the decision to the public, the mobilization of support, and the myriad choices on trade, finance, and investment regulations that determine the extent of the devaluation's effect.

Stage 1: The Arena

Once it is clear that a country cannot meet its payments or faces serious difficulties, there is generally a short period of calm as both the local government and foreign organizations evaluate the circumstances. In this stage decisions are likely to be rational, reflecting the costs and benefits of involvement. Although the outside organizations have the inherent advantage of being able to exit, the ties that develop limit the flexibility of both sides.[31]

Nevertheless, fundamental changes in assessments do occur. In 1978 the Soviet Union switched from supporting Somalia to an extensive involvement in Ethiopia, and between 1966 and 1971, the United States reversed its position from strongly supporting to threatening India.[32] In each case there were dramatic shifts in resource flows. The arena thus provides for a period of mutual sizing up by potential partners, The significance of the devaluing country and the promise of the situation play a key role in determining the volume of resources to be committed.

The arena also helps shape a mutually agreeable operating style. If there is a large transfer of resources involved and decisions are being made at the chief executive level, both sides may want a high-profile relationship. IMF lending to Jamaica, U.S. aid to Israel, and Japanese support for South Korea fit this pattern. To maintain a high-profile interaction, however, there must be tangible signs of economic and security benefits. Without such benefits, the leadership in the devaluing country may be accused of making too many concessions to the foreigners. An alternative approach is to handle the interaction at a more routine, technical level. This keeps the discussion among specialists and tends to be a less volatile situation that can be nurtured for long periods because of its lesser visibility and participants' lower expectations. There is also the possibility that the devaluing country is of such minor importance that a serious relationship never develops. This is a highly asymmetric situation and can pose considerable difficulties for the devaluing country because it cannot be sure of either new resources or high-quality technical advice as the crisis develops. Yet the more usual pattern is for the initial period to circumscribe likely options and produce an agreed agenda.

Stage 2: Bureaucratic Politics

After the basic ground rules have been laid, the bureaucratic politics of the situation move to center stage.[33] The significance of this step will vary with the number, sophistication, and influence of the actors involved. Given the financial gain that could result if traders knew of a planned devaluation, the preparations are closely held. Yet the ideologies, training, and personal agendas of those who actually draft the options need to be sorted out. Dealing with a cohesive, highly skilled group like the economic technocrats in Indonesia is a different experience from negotiating with the bureaucratic disarray in Zaire.[34] In addition, in a country like India with an exceedingly wide spectrum of ideologies, the proposed policy measures reflect that political reality even if the bureaucrats themselves might prefer a different outcome. Thus it is essential to see how the competition among advisers plus the exigencies of the moment mold the final recommendation to the principals.

Stage 3: Executive Decision

Given its importance, the final approval for a devaluation is usually made by the head of government. Although only one of the three chief executives evaluated in this study was questioned directly, we have considerable information about all three from those who dealt with them frequently.[35] The purpose of focusing on the executive decision is to see how political leadership responded to economic crisis.

The first step is generally when the economic staff convinces the political leader that the situation is sufficiently serious to warrant close attention. Then as the various alternatives are brought forward, the options are narrowed. For each case in this book, I discuss the particular circumstances that led each leader to agree to the devaluation.

Once a decision has been made, a host of issues requiring political judgment arise. What should the timing be? Are there drought, holiday, or election periods to be avoided? Although preparations must be kept secret, what planning should be done to mobilize support for the decision and to thwart anticipated criticism?

It is important to know how well the technical economic analysis was presented. Was it accurate? Did the presidents and prime ministers, who are not economists, understand the pervasiveness and significance of the step they were approving? Were there patterns in the way that these political figures responded to difficult economic choices?[36] We know, for example, that Prime Minister Kofi Busia of Ghana was well aware that his finance minister favored the devaluation not so much as a means of solving the trade deficit but as a disguised tax that would yield favorable results in handling the domestic budget deficit. If Busia went that far in analyzing the effects of devaluation, we will want to know why he did not press further to estimate the likely price increases that would result and which groups in society would be most adversely affected.

Stage 4: Implementation

The Indonesian devaluation was seen as part of an overall stabilization program and received only minimal criticism, while the Indian and Ghanaian decisions were the objects of intense controversy and virulent attacks. Clearly we cannot judge the performance of the respective governments by the public reaction alone, but it is reasonable to ask how well the decision makers did with the circumstances they faced.

In 1965 India survived one of the worst droughts in its history. Because there was no record of major droughts in two consecutive years, it is not reasonable to criticize the Indian economists for failing to predict the second drought in 1966. Yet it is sensible to ask why they did not postpone the devaluation for another six to eight weeks when they could have had accurate information on crop yields, which are so important for estimating exports and food imports in India. Similarly it is curious that Prime Minister Busia chose to go ahead with the devaluation in Ghana before the holiday season was over and before he had a firm commitment on future resources from the IMF.

It is also useful to know if the government actually took the steps necessary to improve economic performance and get the benefits from the devaluation. Were export duties lowered? Were government regulations on investment simplified so that business could move into or expand in the export sector? What steps were taken to control inflation so that the new exchange rate would not quickly be overvalued? For example, in 1964 the Park regime in South Korea decided to float its currency until it could determine a reasonable parity, but it began intensive steps to encourage exports and lay the basis for its rapid growth before exchange rate policy was entirely certain.[37]

Finally, did the government make a persuasive case in explaining the need for the devaluation? In Mexico's financial crisis in the fall of 1982, President Lopez Portilla blamed Mexicans who had invested their money overseas and the private banks for his problems. Portilla then used this as an excuse for nationalizing the banks.[38] Much of the Mexican public remained skeptical of Portilla's remarks. Similarly, the Indian and Ghanaian public reactions to their devaluation was exacerbated because the sacrifices being extracted were not well explained. The analysis of implementation will therefore evaluate how appropriate the economic steps were given the known constraints.

Why Analyze Devaluations under Pressure?

It is not possible to give a precise quantitative estimate of the percentage of devaluation decisions made under pressure because many of the deliberations are secret and governments occasionally initiate a devaluation to avoid the appearances of having conceded to foreign pressure. Nonetheless, a study of recent IMF stabilization programs showed that most governments did devalue before, during, or shortly after the provision of IMF standby credit.[39]

Thus, from an analytical standpoint, the appeal of concentrating on devaluations initiated under pressure is that they are clearly an important subset of all devaluations and highlight the tension between the objectives of foreign organizations and the domestic constraints a government faces.

The initial question thus becomes, Does the threat of a foreign exchange crisis produce reasonably predictable government behavior? There is considerable evidence that economic policymakers typically view a foreign exchange shortage as a transient problem and attempt to cope by searching for internal sources of funds. When internal options are exhausted, governmental attention is then often focused on the easiest external sources, like commercial banks and some bilateral donors. Only as a last resort do decision makers acknowledge the need for harsher remedies like devaluation and borrowing from the IMF. If systematic inquiry shows that these patterns show up repeatedly, we have a useful policy guide because it is clearly suboptimal for governments to wait until crises develop before initiating a stricter regime.

An equally important issue about devaluations under pressure is whether the foreign intervention is legitimate. Part of this debate is ideological. Marxists see the foreign pressure as insidious,[40] while many social democratic critics view the process simply as an additional means of preserving an international economic system biased against the LDCs.[41] In the 1960s Western neoclassical economists tended to be confident about their ability to define precisely a country's resource needs,[42] and this led to confidence about the legitimacy of intervention.[43] By the 1970s a much broader debate about the objectives of development was occurring.[44] Some analysts stressed improving the physical quality of life in LDCs.[45] Others preferred a focus on employment and ensuring minimum living standards.[46] And a third group emphasized decontrolling LDC government regulations with renewed reliance on market principles and export promotion.[47]

In the midst of this lively debate on policy objectives, there was also considerable discussion about the effectiveness of the resources and advice provided by foreign organizations. Although certain stabilization programs had clearly been effective in the post–World War II era,[48] doubts increasingly arose about the advisability of stringent policies in a time of resource scarcity when unpopular programs appeared to be only marginally successful in solving balance of payments problems.[49]

Much of this debate has been about the IMF itself. Liberal critics have argued that the IMF is too rigid,[50] too monetarist,[51] and too market oriented.[52] Conservative critics have claimed that the fund has not pressed hard enough to get countries to select realistic exchange rates and has not put enough emphasis on supply-side considerations.[53] Mainstream critics have lamented that the IMF has been only moderately successful at meeting its own stated goals[54] and that it should shift its emphasis toward a new mix of objectives like growth, sectoral balance, and even income distribution.[55]

In the 1980s there has also been greater concern with how the entire international economic environment shaped the real—as distinct from theoretical—options of LDC policymakers. In the decade 1974–1983, there were five years of recession in the developed countries (due to the reactions to the oil price increases), and the LDCs necessarily saw this as a forbidding environment for trying to increase their exports.[56] This meant that many LDC governments had to contract their imports sharply if they were to reduce their trade deficits.[57]

Three case studies will not provide a definitive judgment on the efficacy and legitimacy of foreign-pressured devaluations, but by probing in depth we can identify particular recurring patterns that shape outcomes. Although in the past decade commercial banks have become the target source of finance for LDCs, in many cases the role of the IMF in pressing for devaluation has been strengthened because the private banks have preferred to have the IMF leading the discussion of stabilization measures.

Why Select These Cases?

The India, Indonesia, and Ghana cases illustrate both sufficient similarities and sufficient differences to allow generalizations about devaluations under pressure. Because the central objective is to explore what precipitates devaluations and what determines their success, the variety in the cases will highlight the issues involved.

There would have been some advantages to broadening the sample and making this a more statistical study. Yet work of this kind has been done, and it poses a number of problems in ensuring comparability in the circumstances being measured.[58] In addition, probing these cases in depth permits us to convey their complexity and is useful for making generalizations as long as we demonstrate that it is the differences in the key variables that produced the divergent results.[59]

There are a number of important similarities among the Indian, Indonesian, and Ghanaian devaluation episodes:

- external pressure to devalue
- anticipation that the devaluation and related policy measures would lead to an increase in external resources
- government steps to move toward a more market-oriented mix of policies
- a turning point in policy choice for the respective governments

The main differences were these:

- the structural characteristics of the countries (strategic significance, size of internal market, regime type, and past experience in dealing with foreign donors)
- the factors that drove the governments to devalue
- the breadth and quality of the analytical work that preceded the decision
- the resulting maneuverability available to the respective governments

Although there was variation in the extent of the external pressure (Indonesia getting the least and Ghana the most), each of the national leaders knew that necessary foreign resources would not have been forthcoming unless policy changes were made. Also, despite Indonesia's success at bringing down the inflation rate to 10 percent in 1969, prices had risen 85 percent in 1968, and aid was still supplying 27 percent of government revenues. Hence Suharto's economists still felt the situation was tenuous and could not afford to antagonize aid donors or international organizations.

The differences among the cases are striking. The geopolitical significance of India and Indonesia led to their being offered opportunities that never developed for Ghana. This affected not only the analytic work and style of negotiations but ultimately the maneuverability necessary for a successful devaluation.

Each case is historically significant. The Indian decision of June 6, 1966, is an extraordinary example of a foreign-pressured devaluation. The analytic work that laid the basis for the move was a fourteen-volume study commissioned directly by the president of the World Bank.[60] Chester Bowles, U.S. ambassador to India at the time, leaked a key memo by the U.S. Agency for International Development (USAID) to the *Washington Post* hoping to put extra pressure on President Lyndon Johnson to increase U.S. aid; Mrs. Ghandi's visit to Washington in March 1966 was planned with the explicit purpose of extracting more assistance from the Aid-India Consortium; in April 1966 the Indian planning minister came to Washington and worked out the details for the devaluation and decontrol package in discussions that involved direct negotiations with the president of the World Bank and several meetings with President Johnson. There are few economic policy decisions made by a developing country that involve such a profusion of high-level attention.

The Indonesian case is notable because the Suharto government brought about startling changes in economic policy without high-level foreign involvement. In fact there was a clear understanding between the Indonesian government and aid donors that discussions would be low-profile, technocratic undertakings. The U.S. government limited its aid to one-third of the total and consciously avoided public discussion of policy recommendations from the aid donors. For their part, Suharto's economists had a clear strategy left over from the Dutch: provide cheap rice to the urban areas and cheap textiles to the entire population. While meeting these minimal requirements, the Indonesians then concentrated on resource flows: attempting to maximize aid, expand private foreign investment, and encourage the repatriation of Indonesian capital.[61] This permitted a rise in living standards throughout the stabilization period and made the devaluation untraumatic.[62] The striking aspect of the Indonesian case is how atypical the circumstances were for an LDC. Few other countries may be as fortunate.

The Ghanaian devaluation of December 1971 is an example of foreign pressure producing a bitter result. The Busia government got itself into a serious balance of payments crisis but never received the attention or volume of funds that were so critical in the Indian and Indonesian cases. Because Ghana lacked strategic importance and was of minimal commercial significance, Western donors were not willing to intervene to provide any major expansion of resources or to soften the terms of the IMF. It is ironic to note how dramatically Ghana's fortunes had changed from the period in the late 1950s and early 1960s when Ghana appeared to be the darling of many donors. In that former period Ghana looked as if it had reasonable economic management and Kwame Nkrumah seemed to be extracting aid deftly from both Western and Marxist countries. By the late 1960s, however, Nkrumah had produced an economic disaster, and Ghana was no longer an appealing model for either the donors or other African countries.

This meant that Prime Minister Busia had limited maneuverability. Given Ghana's reduced importance to the donors, the poor planning for the devaluation itself, and the unavoidable reduction in consumer imports, the Busia government was seen domestically in a very unfavorable light. The circumstances created an easy excuse for antigovernment activity and dissent within the military. The Acheampong coup, which overthrew Busia, followed seventeen days later.

Ongoing Problem

Currency devaluation will remain an ongoing problem for LDCs. Virtually all countries face difficulties with a depreciating currency, but the LDCs usually have the least maneuverability. Their foreign exchange reserves are often minimal, their exports are typically concentrated in a few commodities, and structural adjustment is frequently constrained because capital mobility and changes in production technology are slow. Since these problems are relatively predictable, it is useful to examine how governments in different circumstances have taken steps that enhanced or impeded success at managing a devaluation.

One of the central objectives of this book is to provide a framework linking the political and economic constraints facing a devaluing country. Despite the vast economic literature on this subject, there has been little analysis of the political factors influencing outcomes. Foreign advice about devaluation is often purely economic, and in such a political vacuum, LDC decision makers frequently stumble by ignoring key issues. The case studies illustrate the complexity of making decisions on devaluation and how severe the consequences are for some countries.