A Note on Dual/Multiple Exchange Rates

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A Note on Dual/Multiple Exchange Rates

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Introduction

Exchange rates measure the relative prices of different currencies. Usually each country has one official exchange rate regime. Occasionally, however, countries implement dual or multiple exchange rate regimes (DMERs). Currently, five of the Asian Development Bank’s (ADB) developing member countries (DMC) have DMERs in place. DMERs have significant economic implications. In particular, DMERs have largely failed to deliver the beneficial outcomes intended by policymakers and caused various detrimental effects in developing countries. Past experience demonstrates that DMERs are not a quick solution to underlying balance of payments and other economic problems. As such, a dual exchange rate system needs to be transitional in nature. However, too often they are put in place for too long, causing substantial economic damage. Thus, extreme caution must be exercised when considering introducing DMERs. Once in place, steps must be taken to unify the exchange rates as soon as possible.

This brief describes the concepts underlying DMERs, discusses their main economic implications, and outlines lessons from past experiences.

What are Dual and Multiple Exchange Rates?

A country’s balance of payments (BOP) records the transactions it has with the rest of the world. The BOP has two major components. The current account records trade in goods and services, and transfer payments. The capital account records purchases and sales of financial and other assets, such as flows of direct and portfolio investments. Generally, the same exchange rate regime applies to both current and capital account transactions.

Dual exchange rate regimes arise when different international transactions are subject to different official exchange rates. Generally, one exchange rate is applied to current account transactions such as exports and imports, and another exchange rate is used for capital account transactions such as capital flows. The former exchange rates are often fixed and labeled commercial exchange rates. The latter are often allowed to float and termed financial exchange rates.
While a fixed commercial exchange rate and floating financial exchange rate are most commonly adopted, dual exchange rates can take a variety of forms. For example, some countries fix both commercial and financial exchange rates. There are also situations where countries set different exchange rates for different segments of current account transactions, such as for “essential” and “non-essential” imports and exports. In this case, imports of “essential” goods may have a preferential exchange rate while imports of “non-essential” goods may have a discouraging exchange rate. Multiple exchange rates arise when more than two exchange rate regimes are applied to current and capital account transactions. This note focuses on dual exchange rates for simplicity and because multiple exchange rate regimes share many common features with dual exchange rate regimes.

Why Dual Exchange Rates?

Two interlinked motivations generally lie behind the adoption of dual exchange rate regimes. The main one is to provide relief from a balance of payments’ crisis. Countries adopting dual exchange rates often have a fixed exchange rate in place prior to this. Sudden economic shocks can prompt large capital outflow, placing significant pressure on foreign reserves. Defending the existing fixed exchange rate may not be feasible due to the rapid depletion of reserves, while adopting a floating exchange rate or a large devaluation across the board may be considered detrimental. In particular, trade may be severely damaged in the short term by the drastic change in exchange rates. Consequently, countries may opt to implement a DMER by letting the financial rate float while maintaining a fixed and often overvalued commercial rate. The second motivation for implementing DMER is to control inflation. A fixed and relatively overvalued domestic currency reduces import prices, creating more stable domestic price changes and a lower inflation rate.

It was believed that dual rates combine the advantages of both floating and fixed exchange rate regimes. The pegged exchange rate segment can insulate commercial transactions from exchange rate fluctuations, while the floating segment reflects market forces and gives monetary authorities some flexibility in implementing monetary policies.
The Difficulties of Implementing Dual Exchange Rates

Despite their potential advantages, dual exchange rate regimes are fraught with difficulties. Their success hinges on the segmentation of different markets for exchange transactions. Complete segmentation is impossible, however. This is because a dual exchange rate almost always consists of an overvalued domestic currency for current account transactions. The difference in exchange rates for various purposes creates incentives for arbitrage, and there is often illegal leakage between fixed and floating exchange rate markets via such means as overinvoicing imports and underinvoicing exports. The relatively “cheap” foreign currency obtained this way can then be sold in another market for a quick profit. These leakages dampen the effectiveness of dual exchange rates, and generate potential for macroeconomic instability.

Dual exchange rates distort the relative prices of goods and services, and cause inefficiency and welfare losses. The regimes create different conditions for different economic activities, resulting in the misallocation of resources. Inefficiency may result when an industry develops under a favorable foreign exchange rate, as resources allocated to it will not necessarily reflect their true economic costs and benefits.

Dual exchange rates are often associated with exchange controls, and therefore often lead to the emergence of black markets for foreign exchange. The existence of black markets exacerbates the problems associated with dual exchange rate regimes.

Dual exchange rates also undermine exports. Governments often purchase foreign exchange from exporters with overvalued domestic currency. This effectively penalizes those who surrender foreign exchange at the official rate (normally exporters) and rewards those who purchase it at the official rate (some importers and governments). Because governments are often substantial net buyers of foreign exchange, dual exchange rates provide them with an extra means of obtaining revenue as the higher exchange rate in an export industry functions as an export tax (Pinto 1990). Indeed, the use of DMERs has been seen as an implicit means of imposing tariffs or taxes.

Large differences in exchange rates can lead to export smuggling, rent seeking, vested interests, and corruption. Beneficiaries of these regimes may try to keep the systems in place. Such efforts often prolong the inefficient system.
**Experience of Implementing DMERs and the Spread**

The collapse of the Bretton Woods system led many countries to temporarily adopt dual exchange rates in the early 1970s as transitory steps from a fixed to a floating exchange rate regime. Belgium-Luxembourg Economic Union, France, Italy, Netherlands, and United Kingdom were the major European economies to do so at the time. Dual exchange rates were also implemented in other parts of the world, notably Latin America and Africa. Asian economies such as the People’s Republic of China (PRC) have also experimented with DMERs at different stages. Since 2002, Cambodia, Lao PDR, Myanmar, and Turkmenistan are the DMCs implementing dual exchange rates, while Uzbekistan is the DMC operating multiple exchange rates.

The difference between exchange rates is often termed the spread. The spread indicates the degree of distortion created by dual exchange regimes, with a smaller spread indicating smaller detrimental effects. The spread between commercial and financial exchange rates in most European countries has usually been small compared to that of developing countries. For example, while the European range has generally been 1 to 4 percent, the Latin American spread has measured between 15 to 80 percent (Marion 1994). In most Asian economies, domestic currencies are about 10 percent stronger in commercial rates than in financial rates (Kiguel et al. 1997). However, Asia has seen larger spreads. The spread between Turkmenistan’s official rate and the market rate was about 400 percent in 2002, severely hampering investment and economic growth.

Several factors determine the magnitude of spread. An increase in the government deficit particularly widens the spread when financed by money creation. This process increases the supply of domestic currency and leads to a depreciating financial exchange rate, increasing the gap between the financial and the commercial rate. Reserve depletion brought about by increasing the current account deficit can also cause these results, as can large capital outflow because of weak economic performance. Thus, the spread reflects, and is determined by, underlying economic performance and macroeconomic stability.

These detrimental effects of DMER have persuaded most developed economies to unify dual exchange rates. There has been a significant decline in the popularity of dual exchange rates over time. While 41 members of the International Monetary Fund were
using dual or multiple exchange rate regimes in 1984, this number had fallen to 24 in 1998, and only 14 in 2002. Countries are also more cautious about adopting DMERs when confronted by crises. No countries directly affected by the Asian crisis implemented DMERs. Most chose to respond by letting their currencies float.

**Unifying Dual Exchange Rates**

Uniform floating exchange rates are often implemented to unify DMERs. In some cases, however, a single fixed exchange rate regime is introduced. Some countries gradually progress toward unification, while others opt for an “overnight” approach. The transition from DMERs to a single exchange rate regime has been smooth for some and turbulent for others.

Unification reduces government revenue by removing the implicit taxation DMERs create. Given the limited tax instruments available in developing countries, it is possible that the loss of revenue is accompanied by “print money”, thereby raising inflation (Pinto 1990). In Sierra Leone and Zambia, for example, inflation surged when attempts were made to unify exchange rates in the mid-1980s. This, in turn, ushers in prospects of further inflation due to a rising government deficit.

Kiguel et al. (1997) found that the key to successful unification is to choose an exchange rate that is compatible with the rate that would clear the market for portfolio transactions in the short term. Further, the exchange rate system must also be consistent with underlying fiscal policies. Countries that constantly print money to finance budget deficits will face difficulties in unifying exchange rates. This is because the increased money supply and other factors related to the deficit will create ongoing downward pressures on domestic currency and upward pressure on inflation. This was amply demonstrated by the two failed attempts at unification by Argentina during the early 1980s, when the government funded large budget deficits by printing money while trying to use the exchange rate as an anchor for inflation. Countries that seek to bring down inflation and improve the external balance while implementing unification must adopt fiscal and monetary polices that support these objectives. Ghana, Mexico, Turkey, and Venezuela all cut their budget deficits and tightened domestic credit to support the removal of foreign exchange controls. Zambia’s second effort at unification (1985-1987) attempted to reduce the volume of transactions in the black market by using an
auction system in the official market. However, without the support of compatible monetary and fiscal policies, the premium rose and the black market continued to thrive. Success thus depends on government commitment to weather the short-term adverse consequences unification may bring such as a drop in real wages, reduced government revenue, and possible economic contraction.

In some developing countries, the decision to unify dual exchange rates was a reaction to a crisis when inflation was high and the premium was on the rise rather than a well-planned strategy. Mexico’s decision to unify exchange rates was made following the stock market crash of October 1987 in the face of accelerating inflation. Argentina unified the exchange rate to control explosive hyperinflation in 1989. These experiences suggest that dual systems are typically abandoned not because they are no longer needed, but because they are no longer able to protect reserves and maintain low inflation (Kiguel et al. 1997). Ideally countries should unify DMERs as part of a coherent plan rather than wait for such extreme circumstances.

The recent experience of the PRC provides an interesting example of an evolving, developing country exchange rate regime in the Asian Pacific region (Xu 2002). The PRC maintained a fixed exchange rate of RMB1.5 to the dollar from 1950 to 1980. In 1981, an internal settlement rate of RMB2.8 to the dollar was introduced to remedy substantial overvaluation of the RMB. The authorities then gradually devalued the official exchange rate in subsequent years. In late 1986, the PRC introduced a formal secondary foreign exchange market, the swap market, to deal with the growing pressure for the RMB to be devalued and the prevalence of black market activities. In the swap market, the RMB was permitted to trade at a much lower value than the official fixed rate. The overvalued official rate was applied to certain current account transactions, in particular public sector-related activities. The coexistence of an official exchange rate and a swap exchange rate constituted a dual exchange rate regime.

In order to facilitate trade, from the mid-1980s, the PRC government allowed exporters to retain an increasingly large share of foreign exchange earnings. Exporters and importers were also allowed access to the swap market to sell or purchase foreign exchange at the swap rate. This created incentives for rent seeking. Importers could gain by overreporting their import requirements valued at the official exchange rate and then selling the extra foreign exchange in the swap market at the higher swap rate. Exporters could also gain by underreporting their export earnings, and selling unreported foreign exchange earnings in the swap market at higher rates. The significant
illegal leakage between the official and swap markets caused by this fraudulent arbitrage prompted the government to unify the two markets. In January 1994 the official exchange rate and the swap rate were unified at the near swap market rate of RMB8.7 per dollar. The successful unification of the dual exchange rate regime was supported by healthy fiscal and current account balances, buoyant economic performance, and the fact that the unified exchange rate was close to the market clearing rate at the time.

**Lessons Learned**

Developing countries’ experience with dual exchange rates has generally been disappointing. Most countries experienced a high spread between exchange rates, which reduced the insulating effects of these arrangements. DMERs rates often breed vested interest groups, distort the relative prices of goods and services, and cause inefficiency and welfare losses. The balance of payments relief obtained by the adoption of dual systems has frequently been short-lived. Countries that failed to curb overly expansionary monetary and fiscal policies faced foreign exchange demand pressures, which were reflected in balance of payments deficits in the commercial market and in large depreciations of the floating segment of their exchange rates.

These experiences demonstrate that while dual exchange rates can provide limited insulation for domestic economies from external shocks, they are not viable alternatives to sound fiscal and monetary policy for those seeking macroeconomic stability. In particular, they cannot shelter countries from the consequences of persistently expansionary macroeconomic policies.

An initially more painful but eventually more efficient mechanism for dealing with economic shock and inflation is to float a currency if it is pegged. Full depreciation is an option for an already floating currency to bring equilibrium to the foreign exchange market.

While floating a currency or allowing depreciation may be worthwhile measures, political pressure from interest groups may deter developing countries from devaluing or floating a currency across the board. For example, there may be strong pressure to protect imports of “strategic” industries by having an overvalued fixed segment of domestic currency. Loosing potential government revenue resulting from the consequences of DMERs may also deter government efforts to promptly unify exchange regimes. Despite these
considerations, it is in the long-term interests of governments to resist such political pressures and the temptation to introduce DMERS.

DMERs may buy some time for governments, but they are not a quick solution to underlying balance of payments and other economic problems. As such, a dual exchange rate system needs to be transitional in nature. However, too often they are put in place for too long, causing substantial economic damage. Thus, extreme caution must be exercised when considering introducing DMERs. Once in place, steps must be taken to unify the exchange rates as soon as possible.

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