



Special Series on COVID-19

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Official and Parallel Exchange Rates— Recognizing Reality

Simon Gray¹

For all legitimate current account transactions, there should be a single exchange rate. But in some countries, there are two (or more) exchange rates for current account transactions—an “official” rate and a parallel market rate.² This may contravene the country’s obligations under the IMF’s Article VIII.³ Balance of payments weakness and associated exchange rate pressures, related to COVID-19, have seen an increase in such cases. This note discusses the impact of a spread growing over time between the official and parallel market exchange rates for current transactions purposes, and what happens when it is eliminated by a move to a market-clearing rate. “Recognizing reality” by moving to a unified, market-clearing rate for current transactions removes distortions and inefficiencies imposed on the economy by an official rate that is out of line with economic reality, and the inflation consequences of the move—presumptively close to the parallel market rate—tend to be relatively small. Supportive interest rate and fiscal policies are important factors in determining the market-clearing rate, both before and after an exchange rate adjustment.

WHY DOES A PARALLEL FX MARKET EMERGE?

From time to time, a central bank may find that it is no longer able to maintain a managed exchange rate policy for current transactions, that is, to ensure that the supply of foreign exchange (FX) is sufficient to meet legitimate demand at that price.

¹ For more information, contact Simon Gray (sgray@imf.org) of the IMF Monetary and Capital Markets Department.

² Where capital controls are in place, the existence of the controls nearly always results in a parallel FX market, since some economic agents will be prepared to pay a price to evade the controls. A parallel FX market may also exist for illegal transactions even in the absence of capital controls. The discussion in this note refers only to the existence of a parallel market where FX is purchased/sold for legitimate current account transactions.

³ Article VIII Section 3 prohibits multiple currency practices (MCP) without the approval of the IMF. Under the IMF framework, an MCP is defined by the IMF as action by a member or its fiscal agencies that “of itself gives rise to a spread of more than 2 percent between buying and selling rates for spot exchange transactions between the member’s currency and any other member’s currency.” See Decision No. 6790-(81/43) of March 1981, as amended, and currently under review. The existence of multiple exchange rates can also be inconsistent with a member’s obligation not to restrict, without Fund approval, payments, and transfers for current international transactions. While this note focuses on practical aspects of moving to a market-clearing exchange rate, the authorities should be aware of the legal implications of their actions, as they may also impact a country’s ability to use IMF resources. The authorities are encouraged to consult with IMF staff before implementing reforms discussed in this note.

This tends to happen in response to excessive fiscal stimulus—perhaps “supported” by monetary financing—that leads to high inflation and balance of payments weakness, or in response to commodity price shocks. In the wake of the COVID-19 crisis, many economies have been impacted by: commodity price shocks, including through the indirect effect of falling remittances from commodity producing countries; higher prices because of disruptions to global supply chains; and a shortage of FX as tourist inflows dwindle.

But sometimes the authorities are reluctant to allow the exchange rate to adjust fully, and central banks maintain an (overvalued) official exchange rate—that is, an exchange rate that commercial banks and other regulated entities are legally required to use—while attempting to restrict demand. (In the current circumstances, some central banks have held back from undertaking reforms to their exchange rate policy in light of the still very uncertain extent and duration of the COVID-19 impact on the global economy.) They may do so by prioritizing certain transactions, or setting ceilings for certain current payments.⁴ This approach may be supported by a belief that a strong currency will mean higher growth and lower inflation (while ignoring the underlying problems that cause exchange rate weakness), and by those who can profit from privileged access to FX at the official exchange rate (rent-seeking behavior). Some may initially have hoped that an exogenous shock causing exchange rate weakness will quickly be reversed, thus avoiding the need for policy changes, but fail to adjust when the situation is prolonged.

In such cases a parallel market for current transactions will develop. At the extreme, the “parallel” market may be the only reliable source of FX for the majority of participants in the economy. The central bank is acting as if it were a price-maker, but without the “fire-power” (FX that is available and it is willing to use) to implement its chosen price effectively. The parallel rate is a market solution to a problem created by the exchange rate policy. Price levels in the economy are likely to reflect the parallel market rate, either because that is the rate most people have to use, or because those with access to the official rate can benefit by taking excess profits, or expect the possibility of a significant depreciation in the near future and price accordingly.

The parallel market represents a market-clearing rate but may not be “the” market-clearing rate for current account transactions. A market-clearing rate implies an exchange rate at which demand and supply are in balance: those seeking FX for legitimate current account transactions can obtain it freely when demanded, and those holding FX surplus to their immediate needs are willing to sell it. Since the parallel market will be used for not only some current account transactions, but also legitimate capital transactions or illegal transactions—for example, evasion of capital controls, or criminal activities—it may be weaker than a market-clearing rate solely for legitimate current account transactions.⁵

A market-clearing rate does not necessarily require the adoption of a free-floating exchange rate policy. The authorities may be able to ensure that demand and supply are balanced at a fixed exchange rate (for example some Gulf states with long-term fixed nominal rates against the US dollar) or under a managed floating exchange rate regime or by using instruments and policies other than FX transactions to influence the exchange rate.⁶

DISTORTIONS

⁴ Measures such as prioritization of access to FX, imposition of hard ceilings on current transactions, or unduly burdensome requirements for access to FX, may give rise to exchange restrictions subject to the Fund jurisdiction under Article VIII Section 2.

⁵ In a few cases, the parallel market is very small, and the spread to the official rate likewise is small (for example, less than 10–15 percent). The authorities should aim to understand the reason such small markets exist, even if there is no clear macroeconomic significance.

⁶ Hong Kong SAR China is a good example of a market-clearing nominal exchange rate peg supported by fiscal policy.

Maintaining de jure an exchange rate policy that de facto is neither sustained nor sustainable leads to a range of distortions in the economy, reflecting underlying macroeconomic policies and imbalances. An official rate that is markedly stronger than a market-clearing rate means that demand will (virtually always) exceed supply. For many economic agents that are not high enough on the “priority list,” the supply of FX—particularly for large amounts needed by businesses—is unreliable, and the “shoe-leather” costs of obtaining FX are significant.

- **Banks may struggle to find good projects for lending.** Some will be uncompetitive at the official rate, and most businesses are likely to need some imported inputs, even if the bulk of their inputs is domestically sourced, and since they cannot reliably obtain FX when needed, it is always uncertain whether the business will be able to operate effectively and profitably.
- **Foreign direct investment will also be discouraged.** Nonresidents, concerned that constraints in accessing FX for operational inputs would make a venture unviable, may wait for the situation to be corrected before making investments (or may choose in the interim to invest elsewhere). In some cases, they get specific exemption from the FX regime and can retain and use freely the FX they earn abroad.
- **Statistics and corporate accounts will be distorted.** Corporates may post lower than actual profits in order to manage the exchange rate distortions (over-invoicing imports and under-invoicing exports), thus reducing government tax revenues.⁷
- **The interbank FX market will be thin or nonexistent.** Banks and economic agents have a strong incentive to hoard FX, including by holding it abroad.
- **Rent-seeking and dishonest practices are in effect encouraged.** Some economic agents will respond to the incentives by seeking to profit from privileged access to FX at the official rate, or misstate accounts to offset the impact of misaligned official rates on business activities.
- **In general, the uncertain availability of FX tends to be more of an impediment to business development than the price of FX, or the level of interest rates.** Some companies cannot easily use the parallel market for example because transactions have to be auditable; while the notionally cheap official exchange rate is of little value if supply at that price is substantially insufficient to meet needs.

The distortions arising from a substantially overvalued exchange rate are damaging to economic development and unlikely to deliver any macro benefits. Experience suggests that (1) moving to a market-clearing official rate is not in itself likely to lead to a sharp increase in inflation, since prices in the real economy tend to reflect the parallel market exchange rate already and (2) removing the distortions can give a substantial boost to economic development, by removing uncertainty as to the availability of FX and strengthening competitiveness. But the exchange rate will not stabilize—either in nominal or real terms—unless the underlying causes of the (parallel market) exchange rate weakness are addressed.

Short-term, frictional costs of adjustment need to be considered. If the parallel rate is longstanding, economic agents may already have made full adjustment. But the authorities need to consider whether banks and other financial intermediaries are adversely exposed to a large change in the official exchange rate, whether directly or because some customers have borrowed in FX and are not well hedged (or had relied on access to the beneficial official exchange rate to generate profits). Additionally, the impact on the government’s budget, and on any official FX-denominated debt, will need to be taken into account (though both should benefit from longer-term improvements to the economy when distortions are removed). Consideration should also be given to the impact on vulnerable sectors in the population. In practice, the most vulnerable often gain little or no

⁷ Over-invoicing imports would increase import taxes, but reduce profits, while under-invoicing exports would reduce both profits and any export tax.

benefit from an overvalued exchange rate and government subsidies; this needs to be explored on a case by case basis.

FEAR OF TRANSITION

Central banks and ministries of finance may be reluctant to make a “necessary” exchange rate move because of concerns about the transition process and its impact. They know what they want to achieve—a functioning and sustainable FX market that serves the needs of the economy—but do not make the move because of (1) a lack of clarity about the path to that goal and (2) concerns that the transition may be so bumpy/volatile that social or political considerations will derail the reforms before they can deliver the hoped-for benefits. Governments will be uncertain about the net impact on the budget: this will depend on the government’s need for FX (including for debt service); whether imported goods (typically, fuel and some foodstuffs) are government-subsidized; the extent to which taxable profits are hidden because of the distortionary official rate; and likely benefits to the tax base from a stronger future economy. There may be short-term net costs that change to net benefits in the medium term.

The authorities may not want to move to a unified exchange rate, believing that a strong official rate, or multiple rates can be an effective way to achieve (multiple) goals. A strong/stable exchange rate can indeed bring benefits, including stabilizing inflation expectations and supporting financial stability. But if FX is not readily available at this price, the benefits may be fictitious, and the uncertainties may even deliver the opposite results to those desired. Multiple official exchange rates may be used as a way of providing subsidies to critical or vulnerable sectors of the economy, effectively taxing exporters (and other recipients of FX for example from remittances), though the lasting use of such a tax tends to reduce the tax base by damaging the economy’s ability to export, causes misallocation of resources, and leads to significant evasion. Problems in assessing the real cost of such subsidies, difficulties in targeting them, and susceptibility to corrupt practices, also suggest that this is not an efficient approach.

Are there preconditions for a central bank to “recognize reality” and allow the official exchange rate to move to a market-clearing level? The “pre-conditions” will relate to the nature of the move.

- **A step devaluation to a new exchange rate level (whether pursuing nominal or real stability) will require that the fiscal position and balance of payments be sustainable at that level, and the recognition that the adjustment involves a degree of overshoot (since an undershoot would not deliver sustainability, and it is impossible to know precisely what the right level is).** Importantly, the authorities would also need to communicate credibly that future policies would maintain sustainability of the exchange rate, in order to avoid pressures from capital flight.
- **If a more flexible exchange rate regime is to be adopted, then longer-term stability requires a deep and liquid foreign exchange market, intervention strategies for a flexible exchange rate regime, establishing an alternative credible monetary anchor, instruments available for management of exchange rate risk, and appropriate regulation and supervision.⁸ It is impossible to develop all these fully before making the move.** However, the authorities should recognize the (more attainable) need for an ability to adopt an alternative anchor in a timely manner, capacity to implement monetary policy independently, and maintenance of transparency during the transition.
- **Since pressure on fixed exchange rate regimes is frequently a consequence of unsustainable fiscal policies, the authorities need also to be aware that it is not just monetary policy that needs to be implemented well, but that supportive fiscal and macroeconomic policies are crucial.** An appropriate

⁸ Some estimate needs to be made of the likely impact on banks and other financial intermediaries of an exchange rate change, including exposure to companies that may no longer benefit from privileged access to the official rate.

safety net to protect the most vulnerable in society—assuming that they have in practice benefited from the overvalued official exchange rate—should also be factored in.

Some of the questions that decision-makers ask include: Is the parallel market a good indicator of the equilibrium exchange rate? If the exchange rate depreciates sharply, will it quickly find a new level, or might it carry on weakening well beyond an estimated “equilibrium” rate? What will happen to inflation? Might this lead to financial instability if banks or their customers are exposed to exchange rate risk?

These are important questions to ask, but the most important in many if not most cases is this one:

What is the realistic alternative? The authorities may be “pushed” before they are ready to make the change, and if the (parallel) market has already made the move, policies and instruments need to catch up. If a central bank cannot stabilize the exchange rate—that is to say, the actual rate that impacts the economy, rather than an official rate at which some FX is sold to “priority sectors” or those with privileged access⁹—then the alternative may be an official rate but with a backlog of demand, delays in access, and a parallel market rate over which the central bank has no control. The ideal time to move on the exchange rate never comes;¹⁰ a worse time always does.¹¹

Some of the above questions could be rephrased in terms of the parallel market exchange rate. Is the parallel market exchange rate stable, or is it depreciating continually—and if so, what is driving the depreciation? Is the parallel market deep enough to cope with shocks, or is it better characterized as thin and volatile? Are economic agents exposed more to the official or to the parallel market rate?

MAKING THE MOVE

Once the authorities decide to move to a market-clearing rate, there are a number of important questions that economic agents ask, and where the answers (or lack of them) inform the process of market-price formation, and the willingness of economic agents to sell FX into the market. The deeper clarity that the authorities can provide on their policies, the quicker the exchange rate will settle into an equilibrium (though this will rarely be nominal stability against another currency), and the smaller the exchange rate overshoot is likely to be.¹²

Evidence from countries that have undergone significant adjustments in the official exchange rate over the past 10 years or so¹³ suggests that:

- **When the official exchange rate for current account transactions is allowed to move to a market-clearing level, it does not go into freefall—except perhaps if the market-clearing (parallel market) rate was already in freefall (Argentina, Lebanon, and Zimbabwe are recent examples where the parallel market has at times depreciated very rapidly).** If the factors that have caused pressure on the exchange rate persist, then the exchange rate should be expected to carry on weakening.¹⁴

⁹ But insufficient to meet demand at that price.

¹⁰ Some central banks have suggested that adjustment should only be undertaken once a backlog of FX demand has been met (to prevent excessive downward pressure on the exchange rate), or when FX flows are broadly balanced and/or the spread relatively small. In practice, the backlog can never be fully eliminated, and when the pressure is off, governments and central banks avoid difficult policy moves. Morocco may be a rare exception in terms of making a move toward exchange rate flexibility without immediate pressure to do so.

¹¹ Once FX reserves (and credibility) are exhausted, it is much harder to manage a transition.

¹² Exchange rates always overshoot in this sort of adjustment, in large part because no one precisely knows ex ante what the new (temporary) equilibrium rate should be, and the transitional uncertainty tends to depress the exchange rate.

¹³ There are still a number of countries where there is currently a parallel market exchange rate that is some 30–40 percent or weaker than the official rate.

¹⁴ The parallel market rate is representative of a number of factors: insufficient supply at the official rate, capital account transactions, illegal transactions, uncertainty about the authorities’ future policy actions. Not all of these will feed into a liberalized official rate, especially if needed changes to fiscal and monetary policies are credibly undertaken.

- **The context is crucial:** tightening monetary policy at the time of the adjustment is important in helping the market to stabilize, and supportive fiscal policy is essential to stabilization.
- **The price level in the economy prior to the exchange rate adjustment tends to reflect the parallel market exchange rate.** The inflation pass-through from an adjustment to the official exchange rate therefore tends to be muted, particularly if the appropriate policy adjustments are undertaken.
- **A rapid adjustment of the exchange rate is likely to be much less costly to the economy than a gradual approach (“death by a thousand cuts”).** With a gradual approach, interest rates would need to be higher (or financial repression greater) for longer, to offset expectations of further exchange rate depreciation, and the distortions imposed on the economy by the overvalued rate would last longer, while benefits of the move may only start to accrue toward the end of the transition. A gradual approach may never reach equilibrium.
- **A number of central banks and governments do not wait long enough, or undertake sufficient policy adjustments, for the markets to stabilize and economic benefits to be seen.** A number revert to some form of direct control, and/or monetary financing (or financial repression or arrears) and make a second transition later on. While an appropriate policy response can see the real effective exchange rate broadly stabilize within a short period (or even appreciate, if the initial adjustment results in a large overshoot of the equilibrium rate), the benefits to the real economy will take somewhat longer to accrue. If there is insufficient fiscal or monetary tightening, or the economy is hit by an exogenous shock, the exchange rate path will inevitably reflect this.
- **Communication of the change in exchange rate policy is difficult (especially if the transition is protracted) but crucial in helping to stabilize expectations.** Failure to communicate means more uncertainty, and almost certainly more volatility and a larger overshoot. The move cannot be done unobserved: the exchange rate is very visible, and well known.
- **Attempts to coerce economic agents do not work.** Faced with continuing exchange rate pressures, some authorities accuse economic agents of acting as speculators, and attempt to force them to operate with an over-valued exchange rate.¹⁵ Some have sold FX reserves at an unsustainable rate in hopes of forcing the market back. Other than in the very short term, such approaches will not deliver genuine exchange rate stability, and tend to weaken confidence in the authorities’ management of the economy.

In some cases, the exchange rate adjustment is clearly defined, whether or not an explicit policy change is announced. In many cases the adjustment has been made in a short period (up to a few months), though normally preceded by a longer period of policy uncertainty or of preparation for the move. In others, the process has been protracted and taken years. Some central banks have de facto adopted a long-term policy of stabilizing the real effective exchange rate, but in the shorter term a few have alternated between periods of broadly stable nominal rates, and sharp adjustments; while others appear to make an insufficient initial exchange rate adjustment, followed by a larger and more sustainable change to the exchange rate (Azerbaijan, Kazakhstan). In some, the monetary policy response was protracted and tended to lag inflation developments, while in others it was quick and sharp for example, Kazakhstan in 2015.

There is significant variation in the pass-through from the depreciation to inflation. Where (1) the official exchange rate was largely irrelevant (Myanmar in 2012 most obviously) and the economy was already functioning with a free-floating exchange rate (the parallel market is certainly not managed by the central bank), and (2) monetary policy tightening with positive real interest rates was clearly undertaken, the pass-through appears to be relatively muted. A change in the official rate may however impact expectations of future currency

¹⁵ Under the Fund’s rules, moral suasion by the authorities may constitute an “official action” giving rise to exchange restrictions and/or multiple currency practices under Article VIII, Section 2(a) and 3 of the IMF’s Articles of Agreement.

weakness—and so feed through to the parallel market rate—unless monetary and fiscal policy are clearly communicated and are supportive of future exchange rate stability. The degree of fiscal stimulus and of monetary financing are clearly relevant.

The COVID crisis should not deter authorities from moving towards a unified, market-clearing exchange rate for current account transactions. Heightened uncertainties in the COVID-19 context make it all the harder for the authorities to contemplate a change in the exchange rate regime. The authorities' primary focus must of course be on responding to the impact on the population of the pandemic itself, and then on providing some support to the most vulnerable sectors of the economy, and addressing financial stability concerns. But delaying a necessary exchange rate adjustment may exacerbate, rather than ease, pressures on the economy and the financial sector—pressures that will grow over time. And while hoping for the best (an early re-bound of the global and domestic economy), it makes sense to plan for the worst, and to enhance the economy's ability to respond flexibly to future shocks rather than waiting until pressures become more intense.