USAID Exchange Rate Policy Guidance

1.00 Background

1.10 This message conveys USAID policy governing the appropriate exchange rate at which USAID: [a] exchanges dollars for local currency under development assistance, economic support, and operating expense funds; [b] requires deposits of local currency by recipient countries under cash transfer agreements; [c] generates local currency for the host government through the provision of commodities under CIPs; and [d] accounts for host country contributions to projects. The policy guidance presented here does not apply to sales of P.L. 480 commodities. The separate statutory authority and inter-agency guidance governing these commodities are summarized in paragraph 5.10 below.

1.20 Standard USAID project grant and loan agreements in Handbook 3 provide that U.S. funds be exchanged for local currency at the highest rate per U.S. dollar which at the time of the transaction is not unlawful in the recipient country. Cash transfer agreements that require the recipient government to deposit local currencies in special accounts and non-project assistance CIPs that generate local currency, heretofore, have had no such standard exchange clause, but presumably have been implemented on the basis of the same formulation found in the USAID Handbook. Yet, even in those cases where such language is included in the agreements, it may be subject to inconsistent and differing interpretations.

1.30 The purpose of this cable, therefore, is to clarify, reaffirm, and extend USAID exchange rate policy. This message also provides guidance governing the negotiation of exchange rate provisions in new project and non-project assistance agreements and the interpretation of provisions in existing agreements. The guidance reaffirms USAID's commitment to encourage host governments 'o move toward a unified exchange rate, i.e. a single free market-determined rate of foreign exchange. The guidance asserts USAID's determination to obtain in all its currency transactions the highest rate per U.S. dollar not unlawful that is available to anyone on any transaction in a recipient country, while providing operational definitions meant to preclude conflicts with sound economic policy. This guidance therefore alters existing policy for Cash I Transfers and CIPs, and supersedes reference [i] found in paragraph 6 below. The guidance elaborates and replaces the interim guidance issued by LAC, State 030295, January 30, 1986.

2.00 USAID Policy.

2.10 Current Policy Coverage [see refs. in paragraph 6].

2.20 New Policy for Local Currency Exchange, Cash Transfers, CIPs, and Host Country Contributions.

2.21 USAID exchange rate policy as stated in this guidance cable aims at encouraging governments to adopt and move toward unified exchange rates at realistic levels. It is our firm belief that adoption of a freely determined market exchange rate for all transactions is a key element for stabilizing economies and stimulating economic growth. From the standpoint of prudent financial management, application of the exchange rate policy to USAID financial transactions is also important because of the wide impact exchange rates have on our programs and because of the objective to obtain maximum impact from the assistance which we are entrusted to manage. Finally, the goal of one unified market determined exchange rate will help ensure that host country government budgets do not understate [in local currency terms] the cost of resources, especially of imported physical capital obtained concessionally or under commercial terms.

2.22 Henceforth, it shall be USAID policy that U.S. dollar exchanges for local currency, deposits of local currency by recipients to fulfill conditions of ESF Cash Transfers, generations of local currency from the purchase of commodities under CIPs, and the accounting of host country contributions to projects shall be made at the highest rate per U.S. dollar not unlawful that is available to anyone in a recipient country, as further operationally defined below. This rate will be known hereinafter in this guidance as the HR.

2.23 The policy is applicable to all project and non-project assistance and to all mission operating expense transactions in which U.S. dollars are exchanged for local currencies, all cash transfer agreements that require the host country to deposit local currencies in a special account, all CIP agreements and all host country contributions for projects. It is applicable to project and non-project assistance agreements with both governments and non-governmental entities. Non-project assistance is understood to include program assistance and program-type sector assistance.

2.24 This policy does not apply to cash transfer agreements, or those portions of such agreements, that do not require a deposit of local currency into a special account.

2.25 For those local currency expenditures that are charged to U.S. dollar appropriations for project and non-project assistance and for the Operating Expense account, the appropriate exchange rate to use for conversion is the rate of exchange determined by the U.S. government's disbursing agent, the U.S. Treasury, through its authorized disbursing officer, the USDO of the Department of State, on the day the voucher is prepared. The Treasury Financial Manual which contains the cash management policy guidelines that the USDO operates under, states: quote Unless otherwise authorized by Treasury, exchange transaction for accommodation purposes or for official expenditures will be computed at the prevailing rate of exchange [TFM 8070.70], unquote where the prevailing rate is defined to be quote the rate that would be legally available to the U.S. Government for the acquisition of foreign exchange for its official disbursements [TFM 8070.15] unquote. Elsewhere the USDO rate for commercial transactions is defined to be the quote highest legal rate obtainable from a legally authorized exchange dealer unquote [TFM 8070.30b]. If the USDO rate is lower than the HR [it is not likely that it will ever be higher], USAID dollars are to be exchanged at the USDO rate until such time as a satisfactory solution to exchange USAID dollars at a higher rate, be it the HR or not, can be negotiated with the recipient government. USAID missions should consult with the Embassy, the relevant USDO and, as necessary, the U.S. Treasury and take steps to initiate an intensive exchange rate policy dialogue with the recipient government to resolve the situation in a timely fashion, including, if necessary, setting an HR for USAID transactions above the USDO rate.

2.26 Since no U.S. purchase of local currency takes place for non-project assistance CIPs and cash transfers, USAID is not bound by the USDO rate for these transactions and can thus immediately consider setting the HR rate for them and negotiating the change with the host country.

2.30 Procedures and Guidelines for Determining the HR.

2.31 From the short-term operational point of view, HR may mean different types of exchange rates for different countries. The following examples describe the appropriate HRs for different situations. Each mission should use the examples to determine the HR appropriate for its own country circumstance. It is a fairly exhaustive list. The examples should clarify the intent of the HR concept and assist each mission in arriving at an appropriate definition in cases not covered precisely by the examples.

a. In countries where there exists a unified exchange rate freely determined by market forces, the HR is the unified exchange rate.

b. In countries where a freely competitive auction system for foreign exchange has keen developed, the HR is the auction rate. USAID funds can be auctioned off or sold at the latest auction rate.

c. In countries where the commercial banks and other financial institutions are allowed to engage in foreign exchange transactions without being subject to penalty, the HR is the commercial bank rate, or the parallel or free market rate, whichever is higher.

d. In countries where foreign exchange transactions are controlled, but substantial unofficial, parallel or curb markets exist with rates that are significantly and persistently higher than the controlled official exchange rate, the HR is the higher of the commercial bank exchange rate if it exists, the parallel market rate if it exists, or the controlled official exchange rate. An unofficial, parallel or curb market representing an estimated 10 percent or more of total transactions is considered substantial and rates of 10 percent or more above the official rate are considered significantly higher for this purpose. In these countries, in order to help in establishing the HR, USAID missions may wish to negotiate with appropriate government officials to develop an auction system for all USAID dollars. The host country [usually the central bank] and USAID can decide the frequency of the auction on the basis of local currency needs and administrative considerations.

e. In countries where foreign exchange transactions are strictly controlled under a single and official rate, where a parallel or free market foreign exchange market activity is not tolerated, and where there is no visible and tolerated unofficial curb foreign exchange market, the HR is the controlled official exchange rate.

2.32 The HR is not the illegal [i.e., subject to civil or criminal penalty] quote black unquote market rates, no matter how high it might be. In addition, HR does not mean special exchange rates well beyond foreign exchange market equilibrium that some governments have established for the purpose of promoting certain specific foreign exchange objectives, such as to increase earnings from tourism and workers' remittances.

2.33 If literally interpreted and enforced, the quote highest rate not unlawful unquote concept in rare cases could lead to adoption of an exchange rate greater than the market clearing rate, conflicting with sound macro-economics policies. Missions should guard against such an extreme occurrence and inform USAID/W if operational procedures for setting the HR seem to be causing this anomaly to occur.

2.34 Movement Around the HR.

2.34.1 Not all transactions involving exchange rates must use the precise HR figure established by a mission at a given time. Some programs or projects -- for example, those involving private sector activities -- may require somewhat greater flexibility, given the variety of functions that exchange rates may serve in commercial transactions. For example:

[a] In spot currency exchanges at commercial banks, the exchange rates offered are not negotiable; a private borrower that exchanges the proceeds of an USAID loan for local currency at a commercial bank mast accept the exchange rate offered, even if that rate is not the HR.

[b] In credit guaranty projects which use dollar letters of credit to guaranty local currency sub-loans made by a host country bank, exchange rates are used to establish the amount of sub-loan principal to be guarantied without any actual exchange transaction taking place. It has been standard practice in such transactions to use an easily accessible published exchange rate [such as a daily average rate or closing rate]. These exchange rates quite likely will approximate, but not always equal, the HR.

[c] Exchange rates are sometimes arrived at by arm's length negotiation between two parties, such as two banks, or a private firm and a bank, and may differ from the HR for commercially sound reasons.

Insistence on an exchange rate equal to the HR in such circumstances may be counterproductive and inhibit the orderly conduct of business transactions and the increased rate of economic growth that the policy seeks to stimulate.

2.34.2 It is not the purpose of this policy to disturb the conduct of commercial transactions among parties dealing at arm's length simply because USAID is directly or indirectly involved, as long as the exchange rate used is not significantly and persistently different from the HR rate established by a mission. For the purposes of this policy, significantly different and persistently are defined as 10 percent plus or minus and 3 months in duration.

2.40 The Appropriate Exchange Rate To Be Used To Measure Counterpart Contribution.

2.41 The value of the real resource contribution provided by a host country for a project or program generally should be obtained by first pricing the host country's real resource contribution in local currency. This figure then is converted into dollars at the HR current at the time of the project agreement so that USAID and host country contributions can be expressed in one common monetary unit and so that the real resource contribution by the host country can be expressed in percentage and dollar-equivalent terms. Thus, at the signing of an assistance agreement, the host country's real resource contribution is to be expressed both in terms of absolute dollars and a percentage of the total project based on the domestic and foreign prices and the exchange rate existing at that date. This forms the basis for determining host country's absolute real resource contribution and percentage share of the total project throughout its life, and insulates the host country's contribution from the effect of any exchange rate fluctuations which may occur.

2.42 The host country's/recipient's percentage share of project costs may be explicitly re-negotiated on an exceptional basis if such adjustments are considered necessary for purposes of consistency with other USAID assistance objectives, such as encouraging macro-economics policy reform, and reducing domestic inflation. The rationale for such adjustments in host country/recipient contributions should be well documented and the adjustment executed in a project agreement amendment or the equivalent. In no case, unless authorized by waiver in the case of the relatively least developed countries, is the host country contribution, after recalculation of the entire project budget at the new exchange rate, to be an amount less than 25 percent of total project costs. Automatic downward adjustment in host country/recipient percentage contribution due to devaluation, inflation, and similar financial or economic events is not acceptable.

2.50 Devaluation, Excess Dollars, and Host Country Contribution.

2.51 For a project that contains a dollar component to be used to purchase local currency for procurement of goods and services on the local economy, a devaluation not accompanied by a corresponding inflation in the host country may create excess dollars in the sense that fewer dollars are needed for this component than originally contemplated. If it is determined that the original project's objective has been met, that there are excess dollars, and that these extra funds are to be used to either extend the existing project through an amendment or similar document, or are to be used for other projects or programs within the USAID's portfolio, the appropriate counterpart contribution for these activities, if it is determined that such a contribution is required, will be based on the current exchange rate and not the original exchange rate.

2.52 To the extent this policy paper and Handbook 3 conflict, Handbook 3 will be revised to reflect the new provisions. Specifically, the standard counterpart contribution clause in bilateral grants and loans will be amended to reflect the policy.

3.00 Implementation.

3.10 New Agreements.

3.11 For new agreements, GC is reviewing the current model loan and grant agreement language in Handbook 3 to determine whether any changes are needed as a result of this policy. GC will advise missions within 45 days from the date of this guidance message. In the meantime, missions should continue to use the current model quote highest rate...not unlawful unquote language in Handbook 3 as now interpreted by this policy in paragraphs 1.30, 2.20, and 2.30. Exceptions must be justified on a case by case basis as provided in paragraph 4 below.

3.20 Existing Agreements.

3.21 Missions should make best efforts to modify existing project and non-project assistance agreements to reflect the above policy as appropriate. However, existing agreements that do not contain exchange rate clauses, or that provide for rates inconsistent with the policy stated herein, need not be amended to comply with the policy under certain circumstances. These circumstances are: [a] if a host government might view a requirement unilaterally imposed by the U.S. to re-negotiate an existing agreement as quote changing the rules in mid-stream unquote; and [b] if the host government might view a substantial increase in local currency programming due to a higher conversion rate as an unwarranted foreign involvement in domestic budgetary affairs.

3.22 Since the definition of HR herein is consistent with existing Agency policy as expressed in many Bilateral it will not be necessary to amend existing documents in most cases. In those few situations where the Bi-laterals are clearly inconsistent, amendments may be required. GC or the RLAs should be consulted on such issues. Amendments to bilaterals require the Circular 175 process with approval by the Department of State.

3.30 Handling Hyper-inflation.

3.31 In countries with hyper-inflation, USAID missions might negotiate with appropriate host government officials or private borrowers dollar disbursement schemes determined on the basis of needs. Gradual disbursements of dollars would reduce the problem of rapid depreciation of local currency deposited in special accounts.

4.00 Provisions for Exceptions.

4.10 USAID recognizes that there may be circumstances in which deviation from the policy stated in paragraphs 2.22 may be appropriate. We are mindful that the exchange rate issue may be politically sensitive in particular cases. It could be argued that rigid insistence by USAID on the HR would penalize a government that, through the use of multiple exchange rates, is making a good faith effort to move toward a realistic, market-based exchange rate one step at a time -- as opposed to a government that adheres to one artificially low exchange rate for all transactions. Similar situations can be accommodated under this new policy as noted in the discussion of the process for obtaining exceptions to the policy in paragraph 4.20. The HR guidance cases in paragraph 2.31 above were developed as a result of the concern that the insistence on one definition of the exchange rate for all countries might not provide the flexibility over the long run needed to get each country to adopt a unified, market-determined rate.

4.20 During the first year, the Administrator will review all requested exceptions to the policy in order to assure uniform handling of the foreign exchange rate policy as stated in this guidance cable. In consultation with GC, the involved Regional Bureau and PPC will prepare a joint action memorandum for

the Administrator. It can contain a joint recommendation or, when there are unresolved differences of opinion, separate recommendations to the Administrator. This procedure supersedes foreign exchange rate guidance in Handbook 3, Section E on project assistance and establishes additional guidance for Handbook 4 on non-project assistance for cash transfers and CIPs.

4.30 Requests for authorization of an exception to general policy as provided in paragraphs 4.10 and 4.20 shall be in writing and shall identify in detail the economic and foreign policy considerations justifying a departure from the standard HR. Such justification must contain a comprehensive economic analysis of the benefits to be obtained by making the exception or the adverse consequences of failing to do so, and an explanation of the USAID mission's approach for moving the host country to a unified market-determined exchange rate position. In those instances when a bilateral agreement governing the foreign exchange rate for Operating Expense transactions is inconsistent with this policy, amendment of that agreement should be considered. If re-negotiation of the bilateral agreement might jeopardize other provisions that are important to the USG, it might be appropriate to request an exception to the policy for this particular set of transactions. The justification should cover both political and economic aspects of the problem.

5.00 General policy Comments.

5.10 P.L. 480 Agreements.

5.11 The requirement for local currency conversion in P.L. 480 programs is controlled partly by statute [reference [e]] and partly by policy established by the Development Coordination Committee's inter-agency working group on food aid [reference [f]]. These requirements are stated in Article III G and Article II F of Part I of the Title I Agreement, and pertain to two separate categories of local currency transactions involving currencies and commodities respectively.

5.12 The first category involves transactions in which the United Stated accepts local currency instead of dollars in payment for Title I commodities; e.g., currency use payments and re-payments of the loan. For this type of transactions, Article III G of Part I of the Title I agreement provides that the exchange rate must be quote not less favorable... than the highest exchange rate legally obtainable in the importing country and ...not less favorable ... than the highest exchange rate obtainable by any other nation. This provision is interpreted as being relevant to exchange rates for one exchange rate for government to government transactions and another exchange for luxury imports, the former not the latter would be the relevant rate to consider.

5.13 The second category of transactions involves local currency generated by the sale of commodities in country, of which a certain minimum amount [equivalent to the CCC dollar value of the commodities] must be used for agreed upon purposes. Article II, F of Part I of the Title I agreement states that: The exchange rate to be used in calculating this local currency equivalent shall be the rate at which the central monetary authority of the importing country, or its authorized agent, sells foreign exchange for local currency in connection with the commercial import of the same commodities. This language permits USAID to accept a lower exchange rate for agricultural commodities where a multiple exchange rate structure exists. Until such time as it is changed, the standard language governing P.L. 480 transactions shall continue to apply.

5.20 Effects of Overvalued Currency.

5.21 The general USAID policy to encourage host governments to establish one market-determined exchange rate for all transactions will discourage host countries from subsidizing imports and penalizing exports, the two primary effects of an overvalued currency. It will also minimize windfall profits to importers and intermediaries [public, private, and parastatal] who obtain foreign assistance resources at a foreign

exchange rate below the open market rate, and then sell those resources at prices determined by the market rate [reference [g], page 35]. Finally, it is designed to assure that host country government budgets do not understate [in local currency terms] the cost of resources, especially of imported physical capital.

5.22 To the extent this policy guidance accepts an overvalued exchange rate, windfall profits will tend to accrue to importers who obtain USAID supplied commodities at the "highest rate not unlawful" and then sell those commodities at prices determined by a higher parallel rate or by other import restrictions. Elimination of windfall profits is best achieved, as stated in the above paragraph, by an end to overvaluation of the local currency and the establishment of one exchange rate. Alternatively, auctions or surcharges could be used to reduce excessive gains.

5.23 An overvalued currency makes imported capital goods cheaper than they would be if the currency wee properly valued, and leads businesses and governments to purchase more imported capital goods than they otherwise would. As a result, businesses and governments in LDCs will tend to use relatively less of an economy's relatively abundant labor resource and import relatively more capital goods than they would be if the currency were not overvalued.

5.24 Even in the case of a U.S. dollar cash transfer without a special local currency account, a resource allocation distortion resulting from an overvalued currency still occurs as the dollars help finance import needs. The host government and local businesses in their domestic budgetary processes must ultimately value the machinery and equipment in local currency units. At an overvalued exchange rate, this will produce a local currency cost value lower than it would be if the exchange rate were not overvalued, and as noted above, will lead to the use of more imported capital goods than would be the case if the local currency were not overvalued.

6.00 References.

[a] Policy Determination No. 5 on "Programming P.L. 480 Local Currency Generations" [February 22, 1983], which refers to the standard exchange rate provisions in Article II-f of Part I of all P.L. 480 Title I agreements;

[b] State 070833 on "Guidance for Preparation and Submission of Mission Plans for Use of CIP, Cash Transfer and P.L. 480 Local Currency Generations" [March 10, 1984], which states that PD No. 5 applies to CIP and cash transfer activities as well as to P.L. 480 activities;

[c] USAID Handbook 3, Section 6E and Appendix 6A on "The Project Agreement" [September 30, 1982] for both loans and grants;

[d] USAID Handbook 4, Chapter 4A on "Non-project Assistance Agreements" and Chapter 7 on "P.L. 480, Title I Program" [September 30, 1975];

[e] Agricultural Trade Development and Assistance Act of 1954, as amended [P.L. 480], Section 103[h] on exchange rates, and Sections 105, 206, and 305 on special accounts "Legislation on Foreign Relations through 1984", [March 1985];

[f] AIDTO Circular A-487 [July 6, 1974] on "P.L. 480 Title I -- Basic Negotiating Instruction and Draft Agreement";

[g] USAID Program Design and Evaluation Methodology Report No. 4 on "Evaluation Guidelines for Non-Project Assistance [CIPs] and CIP-Like Activities" [August 1985];

[h] Foreign Assistance Act of 1961, as amended, Section 609 on special accounts, “Legislation on Foreign Relations through 1984” [March 1985];

[i] Manual Order No. 1512.1.1 on “The Generation of Local Currency and the Acquisition and Allocation of Local Currency for Technical and Capital Assistance Projects” [September 23, 1970], which is superseded by this policy statement.