When Will We Learn the Easy Lessons?

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EVENTS IN THE WORLD ECONOMY over the past 18 months have led many politicians, policymakers and academics to rethink views they previously held to be almost self evident. It is now commonplace to hear assertions that markets are not "perfect", that capital flows are "excessive", and that something needs to be done to improve the international financial "architecture". Whatever "perfect", "excessive" and "architecture" might mean—for it is rarely clear, even in context—the view behind such assertions seems to be that the problems in the global economy are due to a failure of "the system" rather than to a failure of specific combinations of policies. This is unfortunate, for as complex as the world's current economic problems might be, the past 18 months have surely shown us that some policies invariably end up causing problems. There are some lessons we should have learned many years ago.

The Basic Story

In July of 1997, Thailand's central bank, under the pressure of steady losses in foreign-exchange reserves, abandoned its pegged exchange rate. The baht then began its dramatic six-month plunge against the US dollar. The Malaysian and Philippine currencies provided repeat performances almost immediately, while the Indonesian and South Korean currencies waited a polite interval before beginning their even more dramatic free-falls. The level of economic activity in those countries has since collapsed. Credit has become unavailable, bankruptcies have escalated, and unemployment has increased sharply. Genuine pain and hardship is being felt by many.

World commodity prices were at a cyclical high in the summer of 1997 and were just waiting for a sign of when to drop. With the beginning of the collapse of the Asian economies, and the continued weakness of Japan, world commodity markets could see that a major source of demand would very soon be disappearing. The sign was clear. Over the next year, world commodity prices fell by an average of about 35 percent.

With this fall, raw-materials exporters were badly hurt, and their currencies understandably came under attack. South Africa, Australia, New Zealand, and Canada all suffered significant depreciations against the US dollar. But such events were not unknown in these countries, which is one reason they have chosen to operate flexible exchange rates. Within all of these countries, the depreciations generated some pain, especially for those with large stocks of debt denominated in foreign currencies. But in no case was the depreciation a tragic event. None of these countries have suffered the sudden collapse in activity that occurred in the Asian economies.

The system works well—what the past 18 months have shown us is that some policies invariably end up causing problems.

By the late summer of 1998, all eyes were on Russia—another commodity exporter hurt by the collapse in world prices. The sudden devaluation of the rouble from its pegged value, combined with the partial moratorium on the nearly US$150 billion of foreign debt, set Russia back a few years in the reform process. Only slightly later, those same eyes turned to Brazil to see if it would be able, perhaps with some help from the IMF, to maintain its pegged exchange rate. The *real*, the keystone in the Brazilian stabilisation programme from 1994, had been under increasing pressure since the summer of 1997, both from the decline in world commodity prices and from jittery investors deciding to move their assets to safer countries. Given the amount of Brazil's foreign-denominated debt, a significant devaluation of the *real* would not only generate an enormous crunch in Brazil—and thus in much of Latin America—but would also generate significant banking losses in North America and Europe, with serious implications for credit markets in those countries.

Troubling Talk

It is no surprise that these events sparked much discussion about "fixing" the international financial system. The problems in many crisis economies are not academic—real people are experiencing real pain. And even if the politicians and policymakers know that there is little they can do, they need to show that they care. And so they talk. We hear about the possibility of instituting a so-called Tobin Tax, a tax applied to all international financial transactions, which its advocates claim would reduce the flow of short-term capital and thus smooth out the fluctuations in financial markets. A little thought about such a tax, however, reveals that it would be nearly impossible to implement and would be almost useless unless *all* countries agreed to take part. Since that is infeasible, down goes the Tobin Tax.

The discussions move on to the possibility of imposing capital controls, of which there are as many types as there are currencies. But here it is also clear that a *necessary* (though by no means sufficient) condition for a system of capital controls to be desirable is that the controls be instituted in a similar fashion across the widest possible group of both developing and developed countries. In this case, any negotiations toward an agreement on capital controls would be even more complex and con-

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troversial than the negotiations for the Multilateral Agreement on Investment (MAI), which is about as close to moribund as an agreement can be and still be on the table. So the discussion of widespread capital controls never even gets as far as the table.

The discussants eventually settle for discussing better ways of gathering and processing information—on capital flows, on banking systems, on foreign-exchange reserves, and so on. Since more and better information is almost always a good thing, it is pretty hard to argue against these sorts of initiatives. But getting better information is a far cry from redesigning the international financial system.

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What is most dismaying about these discussions is that, to a large extent, they are based on the premise that the problems in the world economy are fundamentally caused by a financial system that no longer works well. The culprit appears to be "globalisation" with its associated fast-flowing capital. The international financial system, which worked well when capital flows were sluggish, apparently now works poorly because capital flows are "excessive". But the truth is actually quite the opposite. The system works very well; but bad policies now get revealed as such more quickly (and much more violently) due to capital's greater mobility. Blaming the system is like shooting the messenger.

There is a Pattern

Nobody fully understands the cause of today's problems. There have been many countries affected, and details differ between them, both in terms of policies and institutions. Yet, as complicated as recent events are, one clear pattern does emerge.

All of the countries that are now in serious crisis situations—including the Asian economies mentioned above plus Russia (and perhaps, imminently, Brazil)—had accumulated significant amounts of short-term foreign-denominated debt and were pegging the value of their currencies above their free-market values. This is akin to washing down sleeping pills with hard liquor—each drug is not serious on its own, but the combination of the two is lethal.

Foreign debt, denominated in whatever currency, is not inherently a bad thing. There is nothing wrong with one country's citizens or firms borrowing from abroad. The cost of such borrowing is that it must be paid back; the benefit is that domestic investment opportunities get financed at a lower rate than otherwise would be possible.

Pegged exchange rates cause more trouble, but at least have within them the potential means for limiting the damage. Pegging the value of a currency prevents the changes in its value that would otherwise be caused by natural movements in the world prices of traded goods or changes in investors' perceptions of risk. Such changes will always take place, and it is naïve to think that they can be avoided by simply pegging the price of your own currency. The changes will still occur, but with pegged exchange rates their effects will simply appear in different places. A country pegging its exchange rate, and finding itself constantly selling foreign currency in order to maintain the peg, will eventually run short of those foreign-exchange reserves. Eventually, defending the peg is no longer possible, at which point the exchange rate adjusts immediately to its free-market level. When that depreciation occurs, the sudden adjustment will cause pain for many people in the country. Especially painful will be the domestic-currency cost of servicing the foreign-denominated debt.

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So foreign debt is not inherently bad; and pegged exchange rates cannot be sustained if the currency is persistently under attack. But the combination of foreign debt and a pegged, overvalued currency is serious. Furthermore, when a prolonged period of pegging the currency leads domestic firms (and banks) to borrow from abroad to lend domestically, thus racking up huge stocks of foreign debt, the combination becomes truly lethal. This is the situation in which the current group of crisis countries found themselves. When the pegged exchange rates were finally abandoned, as was inevitable, the size and impact of the sudden depreciations were brutal.

The Lesson We Should Have Learned

As complicated as any solution to today's problems might be, the lesson that we should by now have learned is simple: pegged exchange rates cause problems, and countries are better off letting their exchange rates be freely determined in foreign-exchange markets. There is one important exception, and this brings us back to Brazil. In the stabilisation from a hyperinflation, pegging the exchange rate is perhaps the only way to quickly reduce inflationary expectations, and so pegged exchange rates have rightly been an integral part of the elimination of all recent hyperinflations. But this is the exception that proves the rule. Brazil's challenge after its 1994 stabilisation should have been to quickly get back to a flexible exchange rate. Because it chose not to face that challenge during the past four years, it now faces a much more troubling challenge. It must choose between the pain that will be felt if it devalues its currency and the pain that will be felt if it tries to maintain the peg by raising domestic interest rates. This is a tough choice, and there will be no easy decision. But with flexible exchange rates countries never have to make this choice at all. ◆