

# Wanted: An International Exchange Rate Regime!

– **The world financial crisis in retrospect and the missed chance of international policy to learn an important lesson in international finance** –

by

Heiner Flassbeck\*

(forthcoming in: *Internationale Politik und Gesellschaft (International Politics and Society)* 5/ 2000)

## *Executive Summary*

*The world financial crisis is over – but all the problems remain. After the devaluation of the currencies of most of the Asian countries and Russia the acute symptoms of the crisis are gone. But the underlying problems of the world monetary system have not been treated properly. The weakness of the Euro and the strenght of the Yen in the first months of 2000 reveal that there are huge and renewed misalignments between the major currencies which may spill over into the emerging markets. Short term capital flows to the weakest countries are piling up again. The next crisis is just a question of time. When it occurs the Western world will be as unprepared as she had been in 1997. There have been a lot of international meetings and a lot of smoke in the air but international economic policy has been unable to come up with solutions for an adequate exchange rate regime in small open economies as well as for the major players. The dominance of the “market” as the global symbol of wisdom and efficiency has prevented any kind of critical assessment of what has happened in Asia and elsewhere.*

*The official reading of the US – Administration and the IMF is untenable. According to them the attempt of governments to be better than the market and thereby fixing their exchange rates instead of leaving them to the knowledge and the forecasting power of exchange markets has been at the root of the trouble. But it was just the other way round: The decision of so many governments in Europe and Asia to abandon the market solution and to find ways to stabilize the external value of money by means of an anchor approach was the result of many frustrating experiences to cope with the volatility and irrational movements of flexible exchange rates. To recommend to these countries now just to return to the “solution” the failure of which had been the reason to switch to the anchor approach is absurd, cynical and dangerous.*

## I. Introduction

Are international institutions able to learn? The world financial crisis which hit Asia and other countries around the globe in 1997 and 1998 is an extremely good example to test the case. The acute crisis is over. Most of the Asian countries are heading back to high growth rates. Korea and Malaysia are definitively out of the slump, Thailand is hovering but on a good track. Others are worse off: Indonesia is still in a mess and Japan has not yet found a solution for its deflationary depression. Brazil has turned the corner but Argentina has to fight with a huge overvaluation of its currency as the mirror picture of Brazil’s depreciation. Even Russia,

---

\* The author had been Vice–Minister for Finance in Germany and works now as consultant and publicist (<http://www.flassbeck.de>).

which had been the most vulnerable of all the crisis countries, reported positive growth rates in 1999 – for the first time since the beginning of the transformation. What remains?

For many observers the financial crisis had been mainly a crisis of the banking system in the Asian countries whereas the others had to cope with other structural problems like the lack of privatization in Russia or the fiscal burden in Brazil. Even today, after the turnaround of growth rates and signs of an overall improvement in the economic situation, it is a widely perceived view that the banking system in Asia has to be restructured fundamentally whereas Russia and Brazil have to solve their specific “structural problems”. According to this view all the countries could only return to the growth path experienced in the last decades if this restructuring has been completed. But such a view raises more questions than answers. How can countries with a “rotten” banking and financial system like the Asian “Tigers” overcome such a severe crisis just by devaluation of their currencies? How could these countries have been extremely successful in terms of catching up with the western world in the past? No region of the world, outside the part we call today the “western industrialized countries”, has ever accomplished such a long and stable phase of high growth rates as the Asian “Tigers” in the 80s and the 90s. How could Brazil survive most of the 90s in good shape? How could Russia achieve positive growth rates with its state owned monopolies? Why is Japan unable to escape?

The Japanese slump leads to the most important question: Why is it that very different countries had been subject of a banking crisis? On the one hand we have seen the failure of countries with large current account deficits and competitive weaknesses, like Thailand, Malaysia and Korea. On the other hand, and this is a neglected fact of the events which are called “Asian Crisis”, with Japan a country got into trouble with a still very high current account surplus and without fundamental competitive problems. The gulf which separates Japan from the others can be easily identified. The remedy for the acute crisis in the “weak” countries had obviously been a sharp devaluation of their currency vis a vis the rest of the world which even tended to overshoot and had to be fought by buying domestic currency with US- Dollars. In Japan it is just the other way round. The Yen was strong most of the time and in the first months of 2000 Japan faces a revaluation which is unjustified, given the “fundamentals”, and which has to be fought by the central bank by buying foreign currency with Yen.

Paradoxically, this constellation is sometimes taken as a proof that something fundamentally has gone wrong in Asia as countries with weak as well as with strong currencies are hit by the same virus. But if a country has a weak currency because it has a “rotten” banking system, how can a country like Japan have a very strong currency although it seems to have the same weaknesses of the financial structures and the banking system? Thus, the conjecture of a “rottenness” of the banking system in Asia as well as the other “structural” problems around the world is - for a priori reasons - not a convincing hypothesis. There must be other factors which explain the problems of the banking system beyond “rottenness” and there must be other factors to explain the crisis in different “structural” environments. Let us look first at the two different groups of countries in Asia, namely Japan and the Tigers and try to find similarities which do not have common roots in the banking system as such but, nevertheless, may explain the problems in that sector of the economy which have been coming up during the Asian financial crisis. In a third step the analysis shall be opened to the other regions to answer the question whether the new “corner solution doctrine”, favored by the US-Administration, is adequate to avoid future crises.

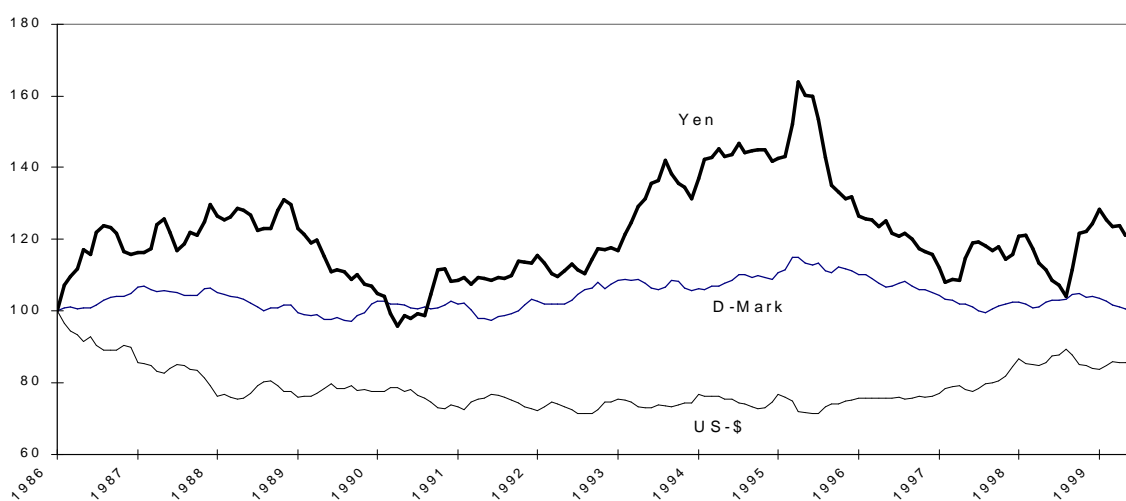
## II. The Japanese Yen and the Way into Deflation

Japan's economy is in a deep crisis for the fourth consecutive year. Although there seemed to be first signs of a recovery in the summer of 1999 the outlook remains rather bleak as there had been a severe setback in the last quarter with overall GDP figures falling again. In the last years a lot of ideas have been launched to explain the persistent slump of an economy which, for decades, had been the role model for many „sclerotic“ economies in the Western World. Most explanations of the Japanese crisis focus on factors like a long isolated and inflexible banking system, the low profit margins of Japanese companies or the kind of cooperatism between the government and the private sector which indeed had characterized the Japanese „model“.

The role of one factor, however, seems to be systematically underestimated even in those analyses which do not only stress the importance of „structural“ causes of the crisis: The exchange rate of the Yen. The Yen had wildly fluctuated in the last 20 years. But erratic fluctuations are not adequate to describe what has happened in the beginning of that period. After the bubble in the stock and real estate market in the first years of the 90s had burst in response to a late but effective tightening of monetary policy, the exchange market entered the stage in an unprecedented and unpredicted manner. The nominal exchange rate of the Yen had already been overshooting the inflation and unit labor cost differentials with the rest of the world throughout the whole of the 70s and the 80s. The resulting real appreciation already falsified the traditionally held theory that the real exchange rate cannot have a trend. But after the sharp recession in the first two years of the 90s things got even worse.

Between 1992 and 1995 the **real** rate of the Yen appreciated, according to different calculation methods, in a range of 50 to 100 %!<sup>1</sup> Not one of the larger economies in the world has ever suffered from such an appreciation shock on top of a long phase of overvaluation. Germany, for example had a real revaluation of around 15% at the same time and was hardly hit by the consequent fall in export volumes, the loss of market shares and a rise in unemploy-

Real Exchange Rate of D-Mark, US-\$ and Yen



ment.

<sup>1</sup> The data in the graph are from the OECD and are based on consumer prices.

A shock like in Japan, five to eight times that large would have led to a big crisis in every country of the world. But, and this is the surprising fact for western observers, in Japan, despite the extraordinary dimension of the shock, neither a sharp drop in market shares nor a rise in unemployment can be observed. The growth rates of exports slowed down, but, according to OECD data, not even touched an absolute reduction. The unemployment rate in Japan rose slightly, employment stagnated but didn't fall.

A huge external shock like the one Japan has experienced after the real appreciation of the Yen in the mid of the 90s would have brought about huge repercussions for the government sector under the institutional arrangements given in Western industrialized economies. Companies would have adjusted their labor force downwards, unemployment would have risen sharply, government deficits would have mushroomed. In Japan, in the first round at least, not much of that happened. As unemployment did hardly rise, the deficit in the public budgets increased slightly up to 1995, not even as much as in one of the major recessions in western countries. Clearly visible is the shock, however, in non-residential fixed capital formation.

There is in my opinion only one explanation for such an outcome. Obviously, in the Japanese system, companies, for a remarkably long time, stabilized the system by bearing most of the unavoidable burden of the huge shock. Keeping the labor force, with the growth rates of total compensation per employee only coming down in small steps, means that the shock had to be absorbed to the largest part by a profit squeeze. Such a profit squeeze would have led, again, under the auspices of a western system, to a sharp reduction of bank lending to companies due to much higher risk of default. In Japan, however, bank lending only stagnated at a rather late stage of the process. Close institutional relations of the banking system with the company sector and an insufficient supervision of banking activities have definitively played a role if we want to explain this kind of burden sharing. Only after the danger of major bank defaults the government had to step in and to consolidate the banking system thereby accepting mushrooming public budget deficits.

The conclusion of this analysis is not as simple as the one which is based on „structural“ explanations of the Japanese crisis. Japanese or Asian institutional arrangements, i.e., the relationship between government, companies and banks, are not per se inferior to western ones. Given the size of the shock that the Japanese society had to absorb in one way or the other, any western economy would have tumbled too. In western societies the government would have stepped in at an earlier stage and employees would have to shoulder the burden in terms of unemployment to a much larger extent from the beginning. In Germany, for example, the small, 15 % real appreciation induced a persistent debate about a fundamental loss of competitiveness and a lack of flexibility in the German society. With an appreciation of the Japanese size most of the existing German institutional arrangements and achievements would have been put in question.

Thus, if adequate room in the analysis of the Japanese crisis is given to the external shock the Japanese economy faced in the first half of the 90s the simple messages lose their persuasive power. Those who explain the visible weaknesses of institutions without taking into account the strain posed upon these institutions by external and, to a certain extent, exogenous shocks, tend to overemphasize “structural factors“ as well as “structural remedies“. This may lead quickly to an “overshooting effect“ concerning the steps recommended to reform institutions. Given many differences in the traditional values of our societies on the one hand and the

Asian economies on the other hand, western advisors should be very careful by recommending to superimpose our institutions over an Asian society<sup>2</sup>.

### 3. Collapsing “Tigers” and other Challenges for the World Monetary System

The story of the slump in the rest of Asia outside Japan is a bit more complicated and needs a bit more theoretical elaboration. The Asian countries had been under pressure from the West during the 80s to liberalize their markets and thus to open their economies for goods as well as for capital. In consequence these countries had to decide about adequate exchange rate regimes under open market conditions. In the light of the experiences of some smaller countries in Europe and a number of newly industrializing countries with a successful stabilization of the price level in the short term, many international observers and advisers, including the IFI's (World Bank and IMF), recommended in recent years that emerging countries including the Asian “Tigers” should employ a fixed exchange rate vis-à-vis Western countries. In these regimes the nominal exchange rate acts as the nominal anchor, giving incentives to all sectors of the economy to adjust their nominal claims to the conditions prevailing in the Western world. Even for large transition economies like Russia, Ukraine, and Kazakhstan this was considered by the IMF and others to be a reasonable strategy<sup>3</sup>. This strategy, the proponents argued, should render the steering of monetary policy and the stabilization of inflation rates easier in countries where the credibility of the central bank is not sufficient to keep a check on inflation in the short term. In the extreme case of the so-called currency board or a full dollarization, monetary policy is deprived of any scope for autonomous action.

The strategy of anchoring a national currency by fixing its nominal rate vis-à-vis a big and stable country has found many supporters in Asia too because it seemed to offer another major advantage compared to domestic solutions. Investment, according to the basic tenet of the school of thought which dominates the IMF and the mainstream of economics today, depends on the prior accumulation of savings. These, however, due to relatively low levels of income are too small in emerging economies, if they exist at all. In Asia the ratio of investment was high but there seemed to be a scarcity of capital which could be healed by opening the borders. It was, according to this view, just necessary to meet certain institutional and procedural requirements in order to get the “necessary” inflow of foreign capital. Anchoring the exchange rate would create stable monetary conditions for foreign as well as for domestic investors. More and more countries therefore turned to the strategy of pegging their exchange rate to some lead currency, just as Austria, for instance, had successfully linked the Schilling to the German Mark for decades.

If such a strategy of pegging the exchange rate is adopted, the nominal interest rate of the anchoring country is fixed at roughly the nominal interest rate of the anchor country, after adjusting for any differences in the rates of inflation. Thus, real interest rates, being the crucial quantity for fixed investment, are, in the eyes of potential investors, in the anchoring country approximately as high as in the anchor country. Additionally, these arrangements do not be-

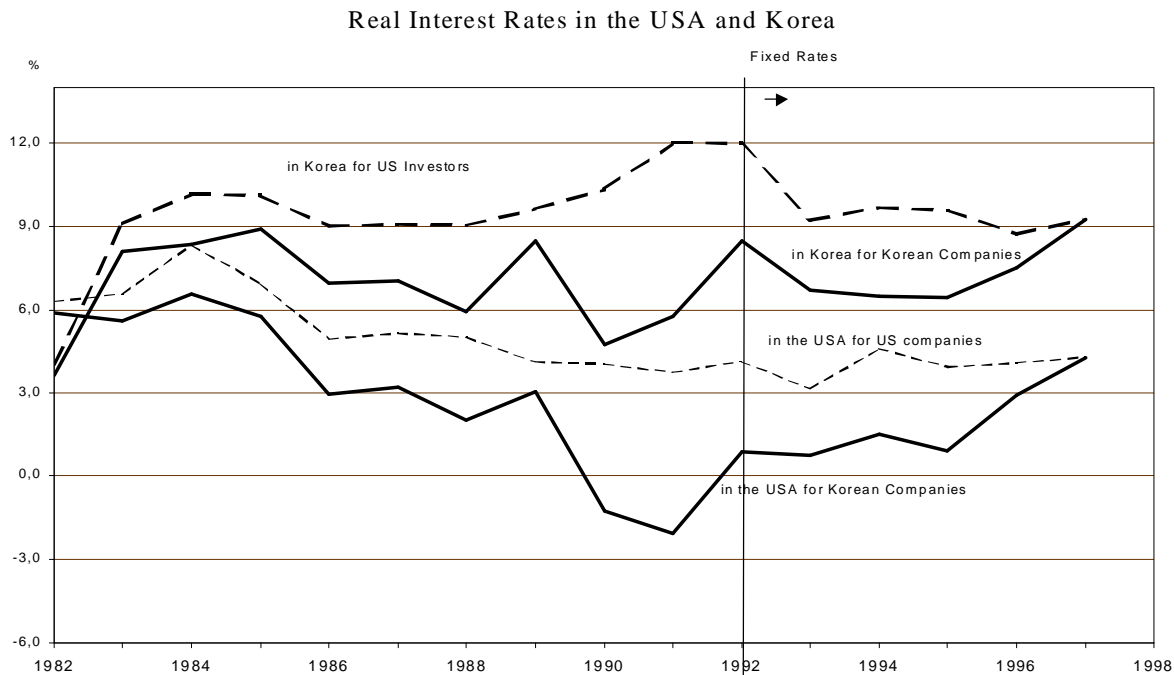
---

<sup>2</sup> The reasons for Japan's failure to overcome the deflationary depression are manifold. Nevertheless, one reason stands out: Japan is the only country in the Western world in which nominal wages have been falling in absolute terms. Falling nominal wages, in stark contrast to textbook models, in reality do not lead to rising employment but to falling demand and, as a consequence, to falling prices. As monetary policy cannot offer negative interest rates economic policy is restricted to fiscal stimuli. But these are compensated in the case of Japan by an appreciation of the Yen. Thus, the only way out is inflationary policy not only by means of monetary policy but by means of some kind of wage policy additionally.

<sup>3</sup> In accordance with concepts promulgated by the IMF, controlling the national money supply was in the first phase of transition seen as the best way to achieve this objective and to accomplish the necessary consolidation of public budgets. However, it soon became clear that this was not a feasible way to fight inflation. In particular, this was true for small open economies which experienced huge exchange rate fluctuations and an unstable money demand.

stow any special advantage on the financing of long-term fixed investment in the anchoring emerging country. If there the expected return on investment is higher (due to the enhanced productivity of capital), the process of catching up becomes possible. But, exactly at this stage of affairs, the monetary conditions, the combination of nominal interest rates and exchange rates is in disequilibrium.

Let us look at Korea, one of the countries in which there had been a successful catching-up



for decades and which collapsed suddenly in the new environment of open markets and fixed exchange rates. The relevant data are in the graph: Korea started fixing the nominal rate more or less in 1992. At that time the real interest rate for a Korean company searching for a loan in Korea was at 8 % and thus quite close to the real growth rate of Korea. But the real rate for a loan in the United States was very low, namely close to zero because nominal rates in the States were much lower than in Korea. For US investors at the same time the real interest rate offered in Korea was close to 10 % and thus much higher than in the States.

Proponents of the “nominal anchor approach” usually overlook the fact that in this situation foreign investors can take advantage of de facto short-term arbitrage opportunities if everybody calculates real interest rates by deflating with his domestic inflation rate. This is reasonable as purchasing goods is not necessarily related to an act of lending in the short term. The differential of nominal interest rates between the countries under consideration corresponds to the one between inflation rates, but, given the anchor approach, there is no risk that the anchoring country’s currency will depreciate in the short run. The inflation rate in the anchoring country is of no concern to the foreign investor, as he calculates with his domestic inflation rate. For him it is important that the rate of return he can earn with financial assets in the anchoring country exceeds the one he could earn at home – if he deflates both by his domestic inflation rates.

The real rate difference is equal to the differential between the rates of inflation. Conversely, it is attractive for debtors in the emerging country to borrow in the anchor country, because they can take advantage of lower nominal interest rates without an exchange-rate risk. Both effects generate a permanent flow of foreign capital to the anchoring (emerging) country. Since wages, unit labor costs and prices rise faster in the newly industrializing country than in

the hard-currency country, the currency of the anchoring country appreciates in real terms, the country loses competitiveness. As a result, the inflow of capital will be mirrored by corresponding deficits in the current account. As a rule, capital inflows will mainly consist of short-term funds, because short-term opportunity for quasi - arbitrage will be a more attractive option than the considerable risks involved in making profitable fixed investments in the anchoring country.

Thus, nominal exchange-rate stabilization destabilizes short-term international capital flows and directly undermines sound banking principles. Exchange-rate stabilization can only be implemented if, during the period of disinflation, the anchoring country offers consistently higher nominal interest rates than hard-currency countries if negative real interest rates in the anchoring country are to be avoided. The inflation-rate differentials between transforming and hard-currency countries are matched by corresponding interest-rate differentials. But, unlike the conditions normally prevailing in the global market for capital, the inflation differentials are not matched by a corresponding risk of depreciation of the anchoring country's currency.

Using the exchange rate as a nominal anchor will inevitably break the link between inflation differentials and the risk of depreciation. If a country chooses to adopt this strategy, its assets become extremely attractive during the period of disinflation, because international investors base their decisions solely on nominal interest rates and the risk of depreciation but not on inflation differentials per se. As a result, speculative capital starts to flow into the country and domestic banks and companies borrow much more abroad than they would if the risk of a depreciation would not have been eliminated de facto. At the same time, as in any period of disinflation the conditions for domestic investment deteriorate. Real interest rates deflated by the actual inflation rate may not be extraordinary high but if the real rate is calculated by using the medium-term inflation target it is usually very high<sup>d</sup>.

Thus, international investors may earn very high rates of return in countries where real income and domestic profits may be falling. Moreover, the transforming country is unable to cut interest rates because this would endanger the credibility of monetary policy at home. In the short term, at least, the political will to achieve economic stability is reflected in the decision to keep nominal interest rates high. Real-world examples of this constellation were provided by the Baltic republics in 1992 and 1993, Mexico in 1994, and Russia, Ukraine and Kazakhstan in 1995 and by Brazil and the Asian Tigers quite recently<sup>d</sup>.

How long an external economic imbalance following the exchange rate peg can be sustained is an open question. With growing visible imbalances the markets willingness to believe in the emerging country's exchange-rate policy will fade. As soon as investors are convinced that the anchoring country will not manage to slow down the growth of its external debt within an adequate period of time, confidence in the exchange-rate's stability deteriorates. Fearing the ultimately inevitable devaluation of the currency, foreign investors withdraw their short-term funds and domestic companies stop borrowing abroad. This will cause liquidity shortages in the anchoring country. At the same time, increasing amounts of this country's

---

<sup>d</sup> An extreme example is Russia where under the supervision of the IMF nominal interest rates reached something like 50 % and real domestic rates even 20 % in the phase of transition and at the beginning of an anchor approach. Accordingly 3- month Russian government bonds (GKO's) have been a big deal for international investors for over two years.

<sup>d</sup> Given the very often unreliable data a simple but straightforward rule to identify a coming exchange rate crisis or a collapse of the real economy in an "emerging market" is the following: If nominal short-term interest rates in a developing or transition economy are higher than in industrialized countries and the nominal exchange rate of the former does not fall at a (annual) rate that equals the difference in (annual) interest rates the constellation of data is not sustainable as either the interest rates or the exchange rate are too high in the "emerging market".

currency are offered for sale in foreign-exchange markets which forces policy makers to restrict liquidity even more. Sooner or later, policymakers have to abandon the exchange-rate peg, which is usually followed by a currency crisis. Enormous dislocations in all sectors of the economy are the result. The problem may be aggravated by close ties and cross-holdings between banks and non-financial business, the government's too hesitant withdrawal from the financial sector, insider lending, adverse selection and moral hazard, but the core of the problem has been the anchor strategy.

The economic situation in Non – Japan Asia was not as extraordinary as many observers believed in the first round. Given the heavy exposure of domestic companies in foreign markets the sharp depreciation of the exchange rates would under any “structural “ conditions have led to enormous problems with the bank's balance sheets. That in Europe similar problems could have been avoided in the past has two reasons. Firstly, there was usually a “safety net” for devaluation as most of the devaluations had taken place with members of certain currency systems, like the EMS. Secondly, an expectation about a certain “necessary” amount of depreciation of the weak currencies had always been in the markets as the differences in nominal exchange rates between countries in a similar stage of development could not be interpreted as a good bargain but as an early warning of a coming depreciation. Nevertheless, even in Europe there had been big devaluations accompanied by banking problems. Sweden in the 90s offers an example. But there is virtually no case where, after a rather long period of exchange rate stability, a currency lost half or more of its value within a short period of time.

In the long run, emerging economies can avoid such an outcome only if they succeed in the control of inflation without letting high real interest rates stifle growth. This means that they have to implement wage and income policies comparable to those in the country whose currency they prefer to pick as an anchor. But there have to be solutions for the phase of transition. Since it is very hard and time-consuming to pursue such wage policies in emerging countries, it is imperative that any solution implemented during the period of adjustment shield these countries from cumulative bouts of devaluation or uncontrolled movements of the exchange rate. There are two ways out: Firstly, an anchor approach with controlled devaluation or, secondly, a crawling peg.

The anchor approach is not a priori unreasonable. Countries may be unable to stabilize the domestic and the external value of their currency at the same time because the political forces may not be strong enough to implement a strategy which is based on domestic measures alone. Italy was a striking example in Europe for the helpful pressure exerted by external restrictions. Brazil too was only successful with its plan to stabilize the Real after the anchor approach had been adopted. But policy makers have to be aware of the dangers inherited with such an approach and there has to be a plan to safeguard the currency from falling beyond any reasonable limits if the unavoidable, the depreciation, is bound to happen<sup>4</sup>.

The crawling peg too has advantages as well as disadvantages. The crawling peg aims at keeping the emerging country's exchange rate constant in real terms. The rationale behind such a crawling peg is simple. The interest rate differential as well as the inflation differential reflect the announced depreciation of the high-inflation-country. In theoretical terms: The exchange rate doesn't follow the interest rate parity but the purchasing power parity even in the short run. Real world examples are most of the Eastern European countries which are in a

---

<sup>4</sup> This is difficult to achieve as politicians usually are proud of their „strong“ currency and fear a renewed outbreak of inflation as soon as the currency is depreciated. Indeed, a certain inflationary setback is unavoidable but if the depreciation is restricted to the degree which is necessary to restore the country's competitiveness it has only a limited impact on domestic inflation. Most important in such cases is that any kind of indexation of wages has been abolished in advance to the depreciation.



stage of transformation still. The best example seems to be Hungary. The country has achieved to stabilize the real rate of the Forint over a couple of years now without being subject to speculative attacks from the markets. But the crawling peg doesn't offer any help concerning pressure on domestic inflation. Economic policy has to be smart enough to bring down domestic inflation by means of monetary policy and/or wage policy.

A policy of controlled flexibility of the exchange rate, be it a crawling peg or an anchor approach with controlled depreciation, will, however, not induce immense capital inflows from abroad. At the very least, controls on the flow of capital have to be considered in order to safeguard the policy. Even though this involves problems of its own, it does not preclude the implementation of a successful strategy of development. Investment activity does not depend on the existence of accumulated savings at home and abroad. Investment in all of the successful cases had been financed through bigger profits and higher levels of employment. In this way, investment generates higher incomes and automatically encourages bigger savings. Thus, the process of development depends less on prior financing through existing savings or capital imports than on a favorable monetary environment for investment in the emerging country itself.

#### 4. Corner Solutions versus Controlled Flexibility?

The lesson international policy on the G-7 level has drawn from this experience of the 90s seems to be very simple: If a country is able to permanently peg its currency vis a vis an anchor country and to avoid a real appreciation, well and good. This is the case of Argentina which is backed by almost all international observers including the United States. If it is unable to do so, there is only one solution left: flexible, i.e. market determined exchange rates. This describes the doctrine of the "corner solutions" which is the final lesson the US-Administration obviously has learned from the world financial crisis beyond the mist of the so-called "world financial architecture". But this solution describes nonsense and it is a catastrophe for the world financial system that the rest of the G-7 now seems to support uncritically the US-Position<sup>7</sup>.

The case can be easily made taking a **post** crisis example of flexible exchange rates, namely Poland since the middle of 1999. The "Financial Times" (FT) on April, 7, 2000 came up with a revealing story. "Poles find strong currency can be a mixed blessing" was the headline of an article which clearly proved how erroneous the "corner solution" proposal is. The FT reports that the Sloty, which had a rather flexible rate at that time<sup>8</sup>, has climbed by more than 10 per cent in nominal terms in the last five months against the Euro despite an annual inflation of 10 per cent in Poland. Polish exports are down more than 13 % year-on-year in the first two months of this year and imports are up. Poland's current account is in deficit since a long time and could reach nearly 10 % per cent in relation to GDP in 2000. The FT, however, doesn't

---

<sup>7</sup> See for a monetary theory of development: H. Flassbeck, Die Weltwirtschaft zu Beginn des 21. Jahrhunderts und die Herausforderung für den Westen, in: Burkart Lutz, zusammen mit Mathias Hartmann und Hartmut Hirsch-Kreinsen (Hrsg.): Produzieren im 21. Jahrhundert-Herausforderungen für die deutsche Industrie. Ergebnisse des Expertenkreises "Zukunftsstrategien", Band 1, Campus Verlag, München 1996.

<sup>8</sup> The new executive director of the IMF, Mr. Horst Köhler, for example said (in the SPIEGEL, 14/2000) that „obviously“ only the corner solutions can work. This is more than perplexing for somebody who had been at the forefront of the creation of the European Monetary Union – a system that could only be built because nobody had ever considered an immediate corner solution in the first 20 years of its evolution. In other words, not one of the countries which are now member of the EMU have ever considered to jump from one corner to the other. Each of them had a transition phase of controlled flexibility, i.e. fixed but adjustable rates.

<sup>9</sup> The Sloty was flexible in a large band of 30 % vis a vis the Euro up to April 2000. Several days after the publication of the FT-article the polish government abandoned the band and made the Sloty fully flexible. The Sloty immediately came under pressure, obviously as a result of the critical discussions in the public about the unjustified and dangerous strenght of the polish currency.

report about the incentives for foreign investors to invest in Poland. Only that tight monetary policy is working is reported. Indeed, monetary policy is rather tight with short term interest rates at more than 12 % in 1999, given an inflation rate of around 7 %.

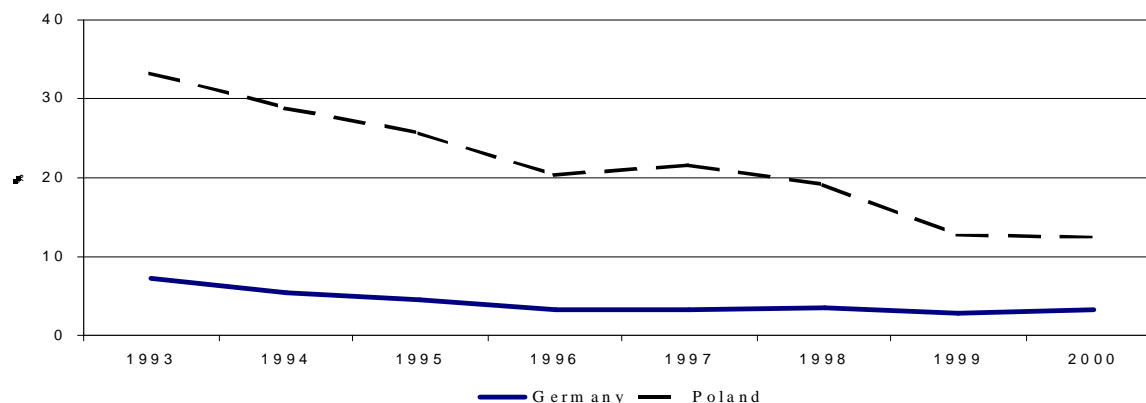
If we look at the interest rate differentials between Germany and Poland, for example, the attractivity of the Sloty is easy to understand (Graph). Nominal rates were always much higher in Poland than in Germany. As long as there are no acute crisis symptoms in the polish economy and thus no acute danger of a depreciation of the Sloty vis a vis the D–Mark it is rational to invest in short term notes in Poland. For polish investors, on the other hand, it is rational to lend in Germany or Euroland if they have access to these markets. And this is true even if you do not get 30 percentage points (or 3000 basis points) “premium” as in 1993 but “only” 10 as in 2000. Thus, after the end of the world financial crisis in which the Sloty had to depreciate too, the flexible exchange rate “solution” was appreciation of the Sloty and not depreciation. In other words, in the short term, the interest rate parity theory holds whereas the purchasing power parity theory doesn’t. But even more than that is true. Would Poland only have fixed its exchange rate vis a vis the D–Mark, the interest rate premium would offer a deal for international investors. But with flexible exchange rates they may be even better off: They earn a very high interest rate plus the gains from the appreciation of the Sloty. In the last five months this accumulated to a profit differential for short term notes vis a vis Germany of more than 30 percentage points.

It is striking how naive in the aftermath of the world financial crisis Polish officials comment on the strength of their currency. The FT reports that the central bank points to the effects of a tight monetary policy on consumer borrowing and that “economists” believe that the countries hard currency reserves are high enough to “easily” withstand an attack on the currency. Nobody seems to understand that these are not the critical points. The question is whether one should withstand an attack and how to avoid an overshooting in case of a justified attack. No country in the world can permanently cope with an overvalued currency. The real challenge for policy makers, as the Asian crisis has shown in unprecedented clarity, is not to avoid the crisis but to contain its effects, inside and outside the country, in reasonable limits. There are no reasons to believe that system of flexible exchange rates will bring about sooner or later a rational solution. The “solution” will be a crisis because this system, given the huge incentives to invest as long as possible in the wrong direction, i. e. against purchasing power parity, can only turn around in panic. The costs of such a solution are extraordinary high as the allocation of resources is distorted before and after the crisis in a manner which by far outweighs the costs of changes in the internal value of money<sup>10</sup>.

---

<sup>10</sup> One of the most striking inconsistencies of modern economics is the different weight it gives to the domestic value of money on the one hand and to the external value of money on the other hand. Whereas the stability of the value of money in time (price stability) seems to be the most important feature of any type of market economy, the value of money in space (stability of the exchange rate) seems to be not important at all. But if strong and unpredictable fluctuations of the value of money in time lead to the kind of misallocation of resources which is attributed to it, the observed fluctuations of the value of money in space must be at least as disastrous as hyperinflation–type of movements in the internal value.

## Nominal Short Term Interest Rates in Poland and Germany



These considerations are not at all new. Already in the 1950s and 1960s, the same dilemma was the subject of a debate concerning England.<sup>11</sup> When capital is free to flow between countries, a system of floating or flexible exchange rates will ultimately be unable effectively to reduce the need for adjustment. It will even be the other way round: With flexible exchange rates in the short term an investment in a developing country may be more attractive as a nominal appreciation adds to the attractive interest rate. This is definitively true for all periods in which the purchasing power theory does not hold and interest rate parity dominates. Developments following this pattern can be observed in many Eastern European countries in the first phase of their transformation.

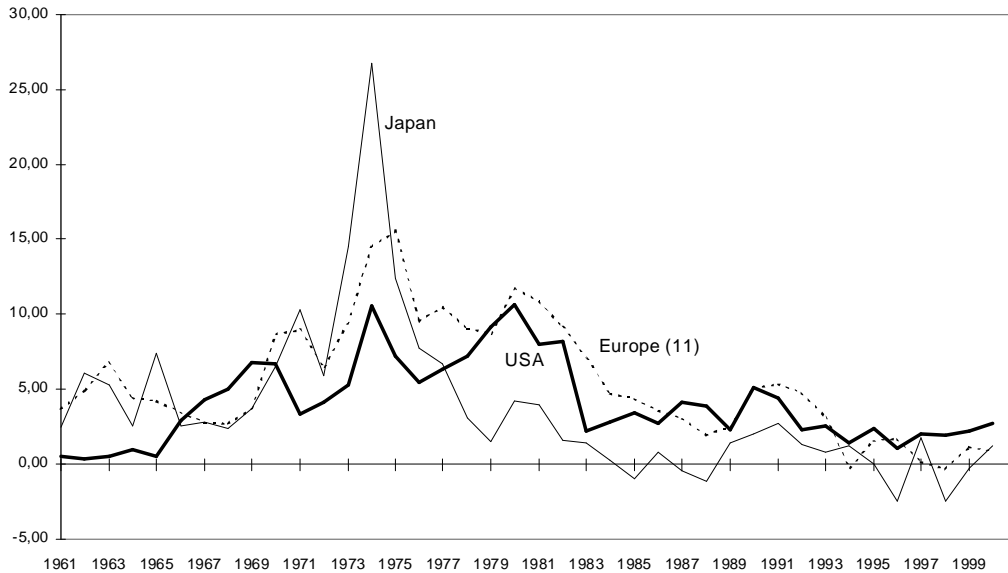
It is the international division of labor which creates the need to adjust with regard to productivity gains and the rise of money wages not an inadequate exchange rate regime. For a while, flexible or adjustable exchange rates may eclipse the necessity of adjustment, but no monetary system can completely eliminate this predicament. Countries which are candidates for a devaluation of their currency, that is, countries with deficits in their balance of payments, or countries with chronically high inflation rates will have to adjust sooner or later. Otherwise they will get caught in a spiral of devaluation and inflation again and again. They can only avoid this if they finally manage to create the kind of domestic conditions that would also be required by a system of absolutely fixed exchange rates or a currency union. In other words, the free flow of capital can only be guaranteed if unit labor costs and prices do not rise faster at home than abroad. Otherwise, various types of currency crisis, or restraints on the free flow of capital, will prove to be inevitable.

<sup>11</sup> J.R. Hicks wrote in 1968: "To adjust the value of money as a once-for-all measure to meet a single identifiable change (such as that caused by a world war) seems to me to be one thing, a continuing failure of competitive power, to be quite another. If currency depreciation is adopted as a regular policy people must come to foresee it. If they do so, they will decline to hold the depreciating currency; for it is more profitable to hold a stable money than one which is depreciating. Even though the 'soft' currency is fortified by exchange restrictions, the objection is not wholly met; for it is doubtful if any practicable exchange restrictions will suffice to protect a currency, depreciation of which has become a habit. In our own case, in view of the advantages which we gain from the use of sterling as an international medium, this argument is particularly powerful. We may be put to great strains in order to maintain the exchange value of sterling (at least to the outsider), but I doubt if we have any alternative but to bear our cross." Hicks (1968), p. 453.

## 5. Euro, Yen and Dollar

But nominal convergence is only the necessary not the sufficient condition for a stable international monetary environment. The degree of convergence within the G-3, the group of large industrialized economies, for example, is impressive.

Nominal Unit Labor Costs in National Currency  
(annual increase in %)



Nevertheless, the degree of exchange rate stability is much less impressive. Although Japan and the Euro 11 have achieved absolute stability of their domestic monetary conditions since a very long time, their currency are subject of speculative attacks in different directions and there is no cooperation within the G-3 to improve the functioning of the global monetary system.

Even the opposite is true. During the Summer of 1999 the Japanese government, for example, has been heavily criticized by Larry Summers, the Treasury Secretary of the United States, for intervening in the exchange market to avoid a further appreciation of the Yen against the US-\$. Instead of leaning against market forces, the Japanese government should rather concentrate their efforts on a stimulation of domestic demand, given the high current account surplus of Japan, urged the critic. At that time Summers was known to have criticized the Europeans too time and again for not stimulating their domestic demand, given their high current account surplus in 1998 and sluggish growth all over the 90s. Not mentioned, however, in the case of Europe was the fact that the Euro depreciated sharply vis a vis the US-\$, thus reducing for Europe the need to stimulate domestic demand as they could expect to export their way out of the slump.

The US Secretary of the Treasury criticizes Japan in their attempt to block an appreciation of the Yen although the Japanese government had been working very hard in the last two years to stimulate domestic demand. But he refrains from asking the Europeans to prevent a depreciation of their currency although Europe has not worked hard at all to stimulate domestic demand. This reveals a strange asymmetry in the argument which is difficult to understand just weighing the facts on both sides. Given the fundamentals in Japan on the one hand and Europe on the other hand, both currencies are clearly candidates for an appreciation vis a vis

the US-\$. Actual inflation differentials as well as expectations concerning future inflation differentials which can be derived from actual growth differentials are clearly not in favor of a strong Dollar. The high overall current account deficit of the US and the bilateral deficits with both partners point in the same direction. Only interest rates are higher in the States than in Japan and Europe. But if this is taken as an argument, the much higher differential with Japan, seen from the US, could only lead to an even more pronounced devaluation of the Yen, not a revaluation, if such a differential justifies the decline of the European currency.

Two currencies with fundamentals pointing in the same direction but de facto moving into opposite directions give economic policy no rational choice. Put it in different way: The US orthodoxy, „leave the exchange rate to the market“ obviously yields contradictory results. If the Yen is not stopped from rising, the Japanese recovery will falter and thus render much more difficult the „job“ of the Japanese government to stimulate demand effectively and help to bring down the global disequilibria in trade. Fortunately for Japan, to stop the rise of the Yen and to give domestic demand via monetary policy a boost are not directly in conflict. This is much more difficult in Europe. If the Euro is stopped from falling by means of monetary policy, e.g. rising interest rates, it may be impossible to stimulate domestic demand. But if the Euro is not stopped from falling European economic policy will not be forced to stimulate domestic demand at all but will again take a free ride on growing exports thereby aggravating the global imbalances in trade. A consistent strategy of the G 3 is without a chance as long as the US sticks to its general dogma of leaving the determination of the exchange rate to the markets.

When questions like these were raised in 1999 by the former German finance minister Lafontaine the US answer was stereotype. Secretary Rubin would have stressed, and he did that in the public before the Spring 99 G 7 finance ministers' meeting in Bonn, a very simple case. He said that from his point of view it would never be reasonable to raise interest rates in a recession just to defend a certain parity, i.e. avoid a depreciation of the US \$ at the high price of deepening the recession. This is an absolutely convincing argument if it describes the relevant situation correctly. But, as illustrated by the Yen case and the Euro case, it may be fully beside the relevant point if the exchange rate doesn't follow Rubin's theory but rather a random walk. The question currently asked in Japan is: How can a deepening of the recession or a renewed slowdown be avoided as monetary policy, due to interest rates already close to zero, has lost its strength and the currency is nevertheless under the pressure of markets to appreciate - not depreciate? There is obviously no answer in Rubin's or Summers' theory to this question.

Exchange rates, left to be determined by the market, do not follow rational paths of adjustment or even facilitate rational decision making by economic policy. Sometimes, by chance, they may help to complement monetary policy in a certain cyclical situation. But as this cannot be expected in a systematic manner there is virtually nothing that can be left to the market alone. Moreover, exchange rate changes, a depreciation for example, may work in the same direction as a reduction in interest rates. But there are additional effects on the allocation of resources. The relative price between tradable and non-tradable goods in every country is changed at the same time as the price between domestically produced and foreign goods is altered. Europe's recovery today is based to a very large part on the effect of a depreciation instead of demand stimuli from economic policy, the overall outcome on production in the European economy may be similar to the one that can be achieved by lowering interest rates. But the necessary by-product of an exchange rate based strategy in Europe is a further increase in the gap between exports and imports on the one hand and an increased profitability of exportable goods compared to non-tradables like services. The opposite occurs in the

United States. In the medium and long run it will become even more important than to turn around this kind of development<sup>12</sup>. Thus, the larger the misalignment today the more probable is a full swing in exchange rates later with all its complementary negative effects on investment in fixed capital on both sides of the Atlantic.

The US-Government will learn the importance of these considerations as soon as growth rates plummet under the burden of higher exchange rates plus higher interest rates. The Euro seems to follow the example of the D-Mark at the beginning of the 80s when, in comparable cyclical circumstances, the D-Mark was under pressure for more than three years with the rate of the D-Mark vis à vis the US-Dollar nearly halved in a very short period of time. The US Government will react as soon as the overvaluation of the US currency is felt in terms of a weakening of the economy. It is only due to successful macroeconomic policy in the 90s that up to today a benign neglect approach of the US administration seemed to be feasible. But the bubbles, including the one that is blowing up between \$ and Euro, will burst. Only an early cooperation between the G 3 can help to avoid what will later be called a major misalignment with all its repercussions on the real economy. The lesson of the 80s is a simple one: There can be preemptive strikes by international monetary policy to avoid unjustified changes in the external value of money and this is justified as the effects of these changes are at least comparable to the effects of dramatic changes in the domestic value of money ( unanticipated inflation or deflation).

Why is it that the market for currencies misaligns time and again whereas we do believe that all the other markets, the markets for everyday consumer goods as well as those for extremely expensive investment goods, work effectively? A radical liberal thinker, F.A.Hayek, has led the way towards a solution. According to Hayek's theory of markets, the goods markets are efficient because on these markets millions of participants collect trillions of individual information units which determine the prices of a huge variety of goods. A government can neither collect nor process this information reasonably and thus cannot produce prices which adequately reflect scarcity. The market for currency is organized in a quite different way. On this market information is collected which stems mostly from government sources like statistical offices or central banks. This information is interpreted in a certain way by, even on a global scale, a few traders. They try to match the views which, like in a beauty pageant, are seen as representing best the views of the majority of traders. The aim of the game is not to buy the product because it is needed to produce or sell something that forms part of an individual act of profit making but to make the highest profit with the best forecast of the final outcome of the game<sup>13</sup>.

That is not to say that exchange rate changes in the global economy are not needed any more. If convergence of the monetary conditions, i.e. the convergence of inflation rates, is not yet achieved exchange rate changes should reflect the resulting differences adequately to equilibrate the competitive positions of regions or nations. But if convergence is given, as in the European Union, and the participating nations have the stamina to stick to their obligations in terms of preserving their competitive level without relying on changes in the value of money, the exchange rate is unnecessary. With the entry into European Monetary Union Europe has achieved an extraordinary success. It has closed one of the biggest casinos in the world and time will tell that this was a rational decision. But the rest of the world is not terra incognita. The European achievement is only a half way house if it is not complemented by more mone-

---

<sup>12</sup> See Heiner Flassbeck: In the long run... ist der Dollar schwach. in: Financial Times Deutschland, 16.3.2000

<sup>13</sup> As a consequence, Hayek clearly opposed flexible exchange rates and favored an international standard. He laid down his position in a more or less forgotten but nevertheless extremely important book in 1937. Cf. F. A. Hayek: Monetary Nationalism and International Stability, in: Reprints of Economic Classics, A. M. Kelley, New York 1971

tary cooperation on the level of the G 3 and regional arrangements between the G 3 and the emerging markets which pave the way for closure of the other casinos in due time.

If the world economy aims at avoiding huge fluctuations in the external value of money and at allowing a very high degree of capital mobility a close cooperation of the big player's central banks and/or a formal exchange rate regime are the only way out. Europe has reached the corner solution of absolute fixed exchange rates. This solution requires a high and permanent convergence of the monetary conditions, i.e., mainly of unit labor costs and prices. But for countries which are not yet able to guarantee this level of nominal convergence there must be solutions between the "corners" of fully flexible or fully fixed rates or the world will tumble from crisis to crisis.

## 6. Conclusion

The emerging markets are back. After the sharp devaluations of emerging market currencies in 1997 and 1998 assets in these countries seem to offer a good bargain again. The inherent problems of the exchange rate regime have not been tackled at all. Short term capital flows to the weakest countries are piling up again and the trade disequilibria grow. The next crisis is only a question of time. When it occurs the Western world will be as unprepared as she had been in 1997. There have been a lot of international meetings and a lot of smoke in the air but international economic policy in the G-7 and in the Ifi's has proved to be unable to understand, to analyze and to heal the underlying sicknesses of the world monetary system. The dominance of the "market" as the global symbol of wisdom and efficiency has prevented any kind of critical assessment of what has happened in Asia and elsewhere.

The official reading of the US – Administration and the IMF is just the opposite of the reasonable interpretation. According to their reading the attempt of governments to be better than the market and thereby fixing their exchange rates instead of leaving them to the knowledge and the forecasting power of exchange markets had been at the root of the trouble. It never came to the minds of the advocates of this economic mainstream view that the decision of so many governments to abandon the market solution and to find ways to stabilize the external value of money by means of an anchor approach was already the result of many frustrating experiences to cope with the volatility and irrational movements of flexible exchange rates in small open economies. To recommend to these countries now just to return to the "solution" the failure of which had been the reason to switch to the anchor approach is absurd, cynical and dangerous.