



Capital Flows and Exchange Rate Policy

By Ellen Frank, Emmanuel College

As neoliberal policies foster greater privatization of the international financial system, countries must rely almost entirely on private financial flows to finance trade, to settle international accounts, even to meet domestic credit needs. In efforts to attract private funds, countries from Thailand and Mexico to Korea and Brazil have deregulated financial transactions, lifting controls on interest rates, on capital flows, and on the convertibility of domestic currencies. For most countries, this tilt toward financial liberalization has proven more a curse than a blessing. Liberalization schemes, particularly those promoted by the International Monetary Fund (IMF) and the U.S., are fraught with dangers and dilemmas for emerging market economies. One of the most damaging consequences of liberalization is that it imposes upon emerging markets a set of unacceptable and ultimately unworkable exchange rate policies.

An overriding goal of U.S.- and IMF-sponsored liberalization programs is to enhance the attractiveness of the target country's financial assets to financial investors. To

be attractive, countries must attempt to insure investors against private financial loss. Governments are advised to permit full and free convertibility of their currencies into U.S. dollars so that investors can enjoy full dollar liquidity. To further minimize investors' risk of dollar losses, countries are encouraged to stabilize the value of their local currencies against the U.S. dollar.

Full and free convertibility, however, has proven to be incompatible with exchange rate stability. Once countries lift controls on short-term capital movements and allow full convertibility of their currencies, the process of exchange rate determination is

privatized as well. For all practical purposes, the external value of a country's currency in a liberalized financial market is determined by speculative trading in the international currency markets—something over which emerging market governments exercise little control. Financial players understand this reality well. But international policy officials routinely misrepresent the dynamics of the financial market. They blame the

inevitable currency crises on internal failures of emerging market governments rather than on the speculative nature of international financial markets.

Governments—like China—that prohibit trading in their currencies can maintain a stable currency peg by preventing private transactions at other than the stated exchange rate. In contrast, countries that allow full convertibility have only weak levers by which to stabilize their exchange rates. Like Argentina, they can institute a currency board, which issues domestic currency only in proportion to foreign exchange reserves. This is not a simple commitment to keep. In practice, a currency board commits the state to intensely restrictive economic policies that serve to curb private lending and slow wage growth—thereby demonstrating to financial markets the state's serious commitment to the dollar peg. Even then, attacks on the currency by speculators can overwhelm the government's ability to maintain the currency peg, as Argentina recently discovered.

Brazil and other governments attempted to stabilize their currencies by catering to the whims and demands of financial markets, adopting restrictive fiscal policies and high interest rates. Implicit in the concept of pegs such as Brazil's is the promise that foreign exchange reserves will, if necessary, be deployed in defense of the peg (to buy domestic currency when speculators are selling it) and that the government will raise interest rates to whatever level is needed to protect investors from currency losses. Countries that wish, like Mexico, to adjust their dollar peg from time to time must generally compensate investors against losses by settling interest rates higher than countries that submit to an unchanging peg.

Emerging market efforts to placate investors with pegged exchange rates, however, have proved pointless in the face of expanded currency speculation. Eventually, the real economic stresses of dollar pegging (repressed economic growth to prevent inflation, current account imbalances) become obvious to speculators, and the gains to be won by attacking the peg (the massive foreign exchange reserves committed to the currency's defense) grow irresistible. Result: speculative assault on the currency, futile and costly efforts by the government to hold the peg, and finally, economic collapse. In the aftermath of the crisis, blame is ascribed: to the government for "overvaluing" its currency; to the IMF for delaying a bailout; to the markets themselves for excessive speculation. The fundamental incompatibility between a privatized financial system and a realistic exchange rate policy is rarely broached.

Key Points

- Countries are under increasing pressure to attract international financial capital to meet trade and balance of payments needs.
- To enhance their attractiveness to investors, countries are urged to allow full and free convertibility of their currencies while attempting to stabilize their exchange rates.
- A stable exchange rate is fundamentally incompatible with unrestricted speculative capital flows. Efforts to stabilize currencies in the wake of speculative assaults are costly and damaging to emerging market economies.

U.S. advice to emerging market governments has been inconsistent, even contradictory, yet the U.S. resolutely refuses to acknowledge its policy failures. Officials in the Clinton administration, as well as in the IMF, are intransigent in their insistence that countries liberalize financial regulations, yet they provide no realistic guidance on how countries are to manage their exchange rates in a speculative and deregulated environment. When liberalized capital flows result in excessive speculation against emerging market currencies, U.S. officials blame exchange rate volatility on emerging market governments who, it is claimed, have caused investors to "lose confidence" in their currencies.

In country after country, the U.S. and the IMF first encouraged countries to stabilize their currencies, and then (when the costs of doing so became intolerable) advised those same countries to abandon their exchange rates to the market, often with devastating effects. The U.S. advised Brazil, for example, to defend its currency against speculators by raising interest rates and cutting government outlays. Indeed, Brazil's defense of its currency became a condition for releasing bailout moneys. That the Brazilian economy was already staggering under short-term interest rates nearing 50% did not seem to faze U.S. officials. Not until Brazil had spent half its foreign exchange reserves defending its dollar peg did U.S. officials—afraid that Brazil would be unable to make payments on its external debt—reluctantly advise a devaluation.

In Thailand, Indonesia, and Korea, U.S. officials blamed speculative attacks on the governments, claiming they had "overvalued" their currencies even though there was no evidence of overvaluation and despite having previously encouraged exchange rate stability to bolster investor confidence. Moreover, U.S. Treasury officials have publicly excoriated efforts by governments to stabilize their currencies by restricting convertibility and short-term capital inflows. Deputy Treasury Secretary Summers called efforts to reinstate capital controls "a catastrophe," yet weeks later accused emerging markets of irresponsibly "lurching for short-term capital." U.S. policy has been characterized by a blindness to the inconsistency of its own advice and an unwillingness to countenance even mild criticism.

Another major problem is that U.S. proposals to avert future currency crises sacrifice the interests of emerging economies and, indeed, increase the likelihood of speculative currency attacks. The policy of defending exchange rates with a combination of high interest rates,

foreign exchange reserves, and IMF-led bailouts has been a virtual invitation to speculators. In 1998 alone, speculators captured \$130 billion in emerging market reserves and nearly \$150 billion in bailout funds. When speculators shifted their focus from Asia to South America last year, the Clinton administration proposed making additional "bailout" funds available with which to defend Latin currencies. Critics immediately pointed out that such a fund, far from dissuading speculation against currencies, would actually embolden speculators by rewarding them for attacking pegged exchange rates.

The evidence that bailout funds that were intended to protect dollar pegs are, in fact, a lure to speculators is now irrefutable. Critics of U.S. policy have argued that emerging markets would be far better advised, in the wake of a speculative attack, to abandon their pegs and lower interest rates, thereby stimulating domestic growth. But such proposals have been met with derision by Treasury officials, who seem to prefer policies that protect international financial interests against currency losses, even if these policies destroy the economies of emerging and indebted countries.

Finally, the U.S. has, in its public statements, refused to consider the obvious linkages between speculative attacks on currencies and the more general failure of the privatized international financial system to provide realistic financing and policy options for emerging markets. U.S. policy regarding exchange rates and capital flows is inseparable from policy related to country indebtedness. Countries are expected to finance debt service payments and trade imbalances with private capital flows and to attract those flows by protecting investors against losses. This policy is a failure. Yet until some alternative means of financing transactions with the rest of the world is devised, indebted countries must expose themselves to speculative capital. As long as the U.S. and the IMF prohibit controls on short-term capital, speculative finance will predominate, and countries will lurch helplessly between futile efforts to sustain damaging and unsustainable pegs and uncontrollable devaluations of their currencies.

Key Problems

- U.S. officials refuse to acknowledge past policy failures, instead blaming emerging market governments for the attacks on their currencies.
 - U.S. policy is geared toward protecting financial firms against losses, often at great cost to emerging market economies.
 - The U.S. has ignored or rejected calls for international financial reform that might give emerging markets more realistic financing and exchange rate options.
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The devastating attacks on East Asian and Latin currencies in recent years have revived calls for international financial restructuring. European governments recently proposed international discussion of a new system for managing exchange rates, credit, and international liquidity—a proposal dismissed by U.S. Treasury officials as “unworkable.” Yet it is the status

Key Recommendations

- Exchange rate policy must be dictated by the demands of development and trade, not by the demands of creditors and private financial markets.
- The power of private financial markets to set exchange rates—and thereby dictate internal economic policy—must be curbed.
- Exchange rate systems must respect the needs and inputs of all participating countries.

quo of global financial markets that is unworkable, because it forces governments into untenable and unacceptable policies in order to protect the wealth of the international financial establishment.

As currently constituted, the international financial system is not only unethical but is also dangerous to economic and ecological stability. When speculators attack the currencies of emerging markets, their losses are covered by the foreign exchange reserves of the

target governments and by bailout packages arranged by the IMF. The target countries are now obliged to replenish these reserves and to repay these bailout funds by selling what resources and labor they can mobilize. In the past year, East Asian countries have vastly increased exports of pulp, lumber, and other commodities at great cost to the environment and to the people of their countries, while the attack on Latin American currencies has precipitated rapid deforestation and land clearing. As world commodity prices collapse, incomes in emerging markets plummet, and the pressure to accelerate unsustainable production intensifies. The world cannot long endure this state of affairs.

International financial policy must be reformed. Reforms should be predicated on the goals of promoting sustainable growth, relieving poverty, and reducing economic conflicts between nations. Countries need to exercise control over their exchange rates in order to pursue internal development goals, yet must, at the same time, agree to be bound by the economic needs of other countries if world tensions are to be alleviated. Emerging markets should be helped to devise exchange rate policies that serve the needs of internal development and recognize the legitimate interests of their trading partners. Exchange rate policy must be dictated by the demands of development and trade—not by the demands of creditors and private financial markets.

All other aspects of the international financial structure should be evaluated on how they best support responsible and development-enhancing exchange rate policies. The U.S. should use its leadership in international organizations like the IMF and the G-7 to promote discussion and development of a supportive international financial architecture. The range of particulars is wide, but any reforms should be founded on three overriding principles.

(1) The power of private financial markets to set exchange rates and thereby dictate internal economic policy must be curbed. This can be accomplished through the reinstatement of capital controls and/or through the establishment of a transaction tax to curb currency trading, as many have proposed. Controls and curbs are only partial solutions, however. By themselves, they can serve to isolate countries from needed international trade and financing opportunities. Internal economic and political pressures may require that countries run imbalances in external payments, and such imbalances need to be financed. If governments are to retain policy independence, financing must be available from sources other than the private market. A publicly organized international lending facility is essential, not (as some have proposed) to act as a lender of last resort to international banks but to serve as a lender of first resort for payments imbalances between sovereign nations.

(2) Exchange rate systems must respect the needs and inputs of all participating countries. The U.S. should not lend its support, tacit or explicit, to any plan for the “dollarization” of Latin American economies or to proposals for a pan-American monetary union. It is not that such an outcome is, in itself, undesirable. There are numerous models for workable and development-enhancing exchange rate systems, and regional monetary unions may well be among the most viable. However, monetary union in the Americas is premature. Monetary unions must be founded on institutions that respect the needs of all participants. No such institutional structure exists in the Americas today, nor do current proposals for monetary union include in their visions a pan-American central bank that is democratic in character. Proposals to dollarize the economies of Argentina or Mexico are driven by the financial elite, who would sacrifice any remaining economic autonomy in South America to protect the dollar value of their wealth. Such plans are not based on any understanding or belief that the dollarized economies would be given a voice in the management of dollar liquidity.

(3) The first priority in debt negotiation must be the stable, sustainable, and democratic development of the world’s economies. The details of international debt restructuring and repayment must be consistent with other development-enhancing changes in the international financial system. Again, the range of particulars is wide, including debt forgiveness, international bankruptcy clauses, and repayment in local currencies or in a newly issued international settlement currency. What is essential is that policy negotiations keep sight of fundamental principles and remember that the financial system must serve the needs of the world economy, not the other way around.

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