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Markets are not perfect, but the alternative is worse

EVEN fervent free-market economists have to admit that foreign-exchange markets sometimes make mistakes. In an ideal world there would be less volatility and fewer misalignments. Is there anything governments can do to make markets work better? Some economists believe so. Their menu offers three main choices: foreign-exchange intervention, international policy co-ordination, and capital controls.

The first choice on the menu is based on the view that governments should intervene more in currency markets to dampen volatility and prevent misalignments. Last year the Bretton Woods Commission, headed by Paul Volcker, a former chairman of America's Federal Reserve, recommended that the IMF set up an intervention fund to help governments fight off speculative attacks.

Currency interventions can be of two sorts. The first is "unsterilised", which means that intervention is allowed to affect the size of the money supply. But since this triggers a change in interest rates, it does not give governments any extra monetary control. The second sort is "sterilised", which means the effect of the change on the money supply is offset through an open-market operation by the central bank.

To support its currency, for example, the central bank may sell foreign exchange for domestic currency, but sterilise the contractionary effect on the monetary base through an equal purchase of government bonds. Since this has no impact on the money supply, it should, in theory, have no permanent effect on the exchange rate. However, some economists argue that in some circumstances it can be a powerful weapon.

Most intervention by central banks is of the sterilised sort. Economists used to think that unless governments were prepared to back up intervention with changes in monetary policy, this was a waste of time; but in recent years some have become more enthusiastic about it. Joint intervention by the big central banks in August seems to have helped to push up the dollar--for a while.

A study published in 1993 by two American economists, Jeffrey Frankel of the University of California at Berkeley and Kathryn Dominguez of Harvard University, concluded that sterilised intervention is more potent than conventionally assumed. They found that in ten of eleven episodes of foreign-exchange intervention by the big central banks between 1985 and 1991, the dollar's rate against the D-mark moved in the desired direction in the following month. Intervention was most effective, the authors found, when publicly announced and internationally co-ordinated. But the evidence is controversial. Concerted intervention is usually a last resort when currencies reach extreme levels--just when a rebound might be expected anyway.

Supporters of foreign-exchange intervention say it works because it sends the market an official signal on exchange rates and future monetary policy intentions, encouraging traders to change their expectations. That makes intervention a potentially useful tool for smoothing disorderly markets or pricking speculative bubbles. But no amount of intervention will work if the economic fundamentals are wrong. As Mr Frankel puts it, "The foreign-exchange market is a 1,000-pound gorilla and intervention is a flimsy leash. When the gorilla has a good idea where it wants to go, there is no point in trying to restrain him. But sometimes the gorilla is willing to be led."

Intervention cannot control the market for long unless it is backed by changes in monetary policy. Moreover, if intervention works through its signalling effect, why send the signal that way? Surely the strongest message that a central bank can convey in support of a currency is to raise interest rates. If the markets interpret intervention as a way of delaying a rise in interest rates, it is more likely to weaken a currency than strengthen it.

Central banks these days have little chance of holding back the tide of international capital flows. In the early 1970s, reserves of central banks in rich industrial economies were around eight times larger than average daily trading in foreign exchange. Latest estimates suggest that foreign-exchange trading is now more than twice the size of currency reserves (see chart 15).

The second offering for stabilising currencies is an old favourite: international policy co-ordination. This was popular in the second half of the 1980s, which spawned countless accords to stabilise the dollar. The Plaza agreement of 1985 bound the G7 countries to co-ordinate their monetary policies and to intervene to drive down the dollar. In the Louvre accord of 1987, the governments promised to support the dollar within an implicit band. The dollar continued to sink.

Target zones were first proposed in the early 1980s by John Williamson, an economist at the Institute for International Economics. According to this blueprint, countries would commit themselves to using monetary and fiscal policy, as well as intervention, to keep their exchange rates within bands of plus or minus 10% around an equilibrium real exchange rate, which would be regularly adjusted in line with inflation differentials. The idea is to discourage speculation that could lead to serious misalignment but retain some of the benefits of floating rates.

The trouble with passion

However, as Benjamin Cohen of the University of California at Santa Barbara puts it, "International monetary co-operation, like passionate love, is a good thing, but difficult to sustain." Experience shows that policy co-ordination between the three big economies, America, Japan and Germany, is politically impractical, because governments are not willing to subordinate national economic policy to an international target. It is hard enough to get agreement on interest-rate changes; on fiscal policy it is near-impossible. And yet it was fiscal policy that was largely to blame for the two greatest exchange-rate upsets in recent years--in America in the 1980s and Germany after unification.

Another snag is that nobody is sure what might be the "right" level for the dollar, or any other currency. There is no reason why governments should be better judges than the markets. Moreover, even if the governments of the big three economies could agree on policies to keep currencies within their bands, target zones would still be vulnerable to speculative attack as rates approached their limits. In a world of highly mobile capital, there may be no comfortable middle ground between floating exchange rates and permanently fixed rates. Pegged but adjustable exchange rates tend to be unstable.

Speculative attacks come in two main varieties. They can be motivated by imbalances in economic fundamentals (such as a monetary policy, an inflation rate or a current-account balance that is incompatible with the exchange rate); or they may be of the self-fulfilling kind. A currency may be successfully attacked, even if monetary and fiscal policies are sound, because markets believe that an attack will cause monetary policy to be eased, and are proved right.

The ERM debacles in 1992 and 1993 illustrate the vulnerability of pegged but adjustable exchange rates to speculative attacks even when governments claim to be fully committed to monetary policies that are consistent with the current exchange rate. French politicians like to blame an Anglo-Saxon conspiracy to destroy the European Union, but speculators were actually responding to macroeconomic divergences. The fiscal burden of German unification required the Bundesbank to raise German interest rates to control inflation at a time when the rest of Europe was in deep recession and unemployment was rising. Countries such as Britain and France were committed to keeping interest rates high to defend their currencies, but the markets believed that double-digit unemployment made higher interest rates politically untenable. The attack therefore became self-fulfilling.

A study by Barry Eichengreen, Andrew Rose and Charles Wyplosz examined speculative attacks on pegged exchange rates in 22 countries over the 25 years to 1992. This period covered the ERM, its forerunner, the Snake, and Bretton Woods. The authors found that apart from the ERM episodes, the attacks were mostly of the first kind, triggered by loose monetary policy or a large budget deficit. For the ERM countries, however, speculative attacks could not, in general, be explained by unsound monetary and fiscal policies. The authors concluded that the scope for self-fulfilling attacks on currencies has increased as capital flows have become more mobile. If so, say some economists, governments need more powerful weapons to tame the markets. Since the ERM crises of 1992 and 1993, they have been arguing for the reintroduction of capital controls to discourage speculators. Such controls would have to be different from those of the old days, when banks were not allowed to lend to foreigners and individuals could not hold foreign-currency assets or have foreign bank accounts. Restrictions of that kind would be virtually impossible to enforce in a world of modern telecommunications and new financial instruments. Even in the 1960s people found many ways to dodge controls; today the rules would be easier still to get round.

Heads stuck in the sand

Advocates of capital controls have something more sophisticated in mind. Rather than trying to ban speculation, they would put people off by making it expensive. The favourite scheme is the so-called Tobin tax, named after James Tobin, a Nobel prize-winner in economics, who first proposed it in 1978 as a way of "throwing sand in the wheels of international finance", to reduce the risk of speculative bubbles and to increase national autonomy over monetary policy.

The idea is that governments would impose a modest tax of, say, 0.5% on all foreign-exchange transactions. Making speculation more costly, claim the proposal's supporters, would sharpen the market's focus on long-term fundamentals. The tax would bear heavily on short-term trading, but leave long-term investment little affected because it would be spread over a longer period of time. For example, a transactions tax of 0.5% on purchases and sales of foreign exchange would be equivalent to an annual rate of over 3,500% on an overnight round trip, to a rate of 4% on a three-month investment, and to a rate of only 0.1% on an investment over ten years.

An alternative proposed by Mr Eichengreen and Mr Wyplosz would require banks to make compulsory non-interest-bearing deposits with the central bank in some proportion to all their domestic-currency lending to non-residents. Currency traders wanting to bet against the franc, say, by selling it short, would have to borrow francs from French banks. Compulsory deposits would therefore make speculative sales of a currency more costly. Mr Eichengreen and Mr Wyplosz think that this would reduce the prospect of self-fulfilling speculative attacks in the run-up to European monetary union.

The idea of a financial-transactions tax to rebuff financial markets pops up as frequently as reported sightings of the Loch Ness monster. Its biggest supporter today is, unsurprisingly, the French government. However, most economists reckon that in practice a Tobin tax would not work, nor would it be desirable. The main problem is that it would be unenforceable. Thanks to integrated and innovative international financial markets, it would be easy to dodge unless its coverage was world-wide. Even if all the OECD economies imposed the tax, trading would simply move offshore to Singapore and Hong Kong. The tax would also have to cover the whole array of financial transactions, not just spot foreign-exchange trading; otherwise investors could achieve the same effect with derivatives (which would be much harder to tax).

But even if the tax could be enforced, it might not stabilise currencies. By discouraging transactions, it would reduce liquidity in the market, which could well lead to greater volatility. More fundamentally, short-term trading is not the only factor which moves exchange rates off their equilibrium. The most spectacular overshoots in recent years have been in property markets, where horizons are much longer and where transaction costs are already high compared with other markets.

A third argument against transactions taxes is that they would reduce the efficiency of financial markets and increase the cost of capital. If effective, such a tax would discourage good capital flows (such as trade credit, hedging operations associated with trade and foreign direct investment) as well as bad ones. In its 1995 Economic Survey, the UN describes the Tobin tax as "a sort of Luddite proposal" in that it tries to reverse the general decline in the cost of international financial transactions.

There may be a case for capital controls of some sort in developing countries to moderate short-term capital inflows for a while. Heavy inflows can cause big problems for emerging economies, pushing up exchange rates to uncompetitive levels or fuelling inflation, not to mention the risk that inflows may suddenly change direction. The IMF suggests that in developing countries some controls on capital inflows may be justified as a temporary measure, but points out that they will gradually become less effective and more harmful. In developed countries, where financial markets are more sophisticated, few economists think such controls have a chance--particularly if used to block capital outflows. None of the countries which used them during the ERM turmoil in 1992-93--Ireland, Portugal and Spain--avoided devaluation.

Don't shoot the messenger

None of these proposed cures seems workable. And although, as outlined above, capital controls may be desirable in some circumstances, they risk ignoring a deeper malaise: attacks on currencies often do reflect economic imbalances. Speculators do not choose their targets randomly; they are more likely to be betting with fundamentals than against them.

Capital flows are an economic barometer, conveying useful information based on the opinions of large numbers of investors who scrutinise economic indicators. Those who favour capital controls are making the dangerous assumption that policy-makers know better than all these players in the market.

If capital controls allow governments to delay adjustment and so prolong underlying economic disequilibrium, they will encourage greater volatility and misalignments over time. When the market correction comes, as it inevitably will, it will prove even more painful. In this sense, if speculators force earlier changes in unsustainable policies, they help to stabilise exchange rates. The longer a devaluation is delayed, the bigger it needs to be. And a crisis in financial markets can be a blessing in disguise if it forces a government to eliminate its budget deficit sooner rather than later. "Is it better to sit on the kerb and bleed to death, or get hit by a bus and be taken to hospital and saved?" asks Robert Johnson, who used to work for George Soros and is now at Moore Capital Management.

Trying to manipulate exchange rates can also be dangerous. Financial markets are now so integrated that if volatility in one market is suppressed, it will simply pop up somewhere else. In the late 1980s, for example, the Bank of Japan's efforts to prop up the dollar led to an overly lax monetary policy which inflated a speculative bubble in property and equities. Attempts to stabilise the dollar have been blamed for the stockmarket crash of 1987.

Yet even if governments cannot control unruly financial markets, that does not mean they should be indifferent to potential risks to the financial system. Volatile exchange rates and bond yields can endanger the safety of financial institutions. The Mexican crisis showed how disturbances in one market will quickly spread to others. Governments can at least ensure that participants are aware of the risks they are taking on, and that the financial system is sufficiently sound to withstand price volatility and some inevitable losses.

The lesson from the collapse of Barings and other financial disasters involving derivatives is not that financial innovation should be curbed, but that firms need to be encouraged to improve their internal risk-management controls. More accurate accounting practices and greater disclosure requirements would help to improve market transparency, as would increased exchange of information between central banks and supervisory bodies in different countries. That is about as far as supervisors can go without creating moral-hazard problems by encouraging excessive risk-taking.

Moreover, even the best-designed regulatory and supervisory framework for financial markets can work only if economic policies and performance are sound. The next section will explore the rules which governments must come to grips with if they are to meet the new challenges of the global capital market.

"Does Foreign Exchange Intervention Work?", K Dominguez and J. Frankel

"Speculative Attacks on Pegged Exchange Rates", by B. Eichengreen, A. Rose and C. Wyplosz, CEPR discussion paper no. 1060

"Two Cases for Sand in the Wheels of International Finance", B. Eichengreen, J. Tobin and C. Wyplosz

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