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III Managing Exchange Rates and Capital Flows

During the Bretton Woods era, international short-term capital flows were modest and generally subject to governmental restrictions. Coordinated foreign exchange market intervention and modest levels of balance of payments lending (e.g., from the IMF and surplus-country central banks to deficit countries) were sufficient to maintain fixed exchange rates because private capital flows were relatively small. The abandonment of fixed exchange rates in 1971-73, in the face of growing private international capital flows, did not mean the abandonment of efforts to stabilize exchange rates and international financial markets, but the subsequent growth of private international finance and of foreign exchange trading in particular means that the task of managing short-term finance and exchange rates is much more difficult today.

Foreign exchange market volatility in the 1990s has generated the same two broad policy approaches as characterized debates about macroeconomic policy coordination: Bringing government policies more into conformity with market preferences (combined with measures to make markets more efficient) in the hope that this will make markets more stable; and collaborative measures to directly influence and control international markets. The G7 has generally favoured the first approach, although recent international financial crises have triggered discussion of more direct market interventions.

The G7 finance ministers have repeatedly claimed that “the pursuit of sound domestic monetary and fiscal policies” is the key to achieving greater exchange rate stability, especially by reducing inflation rate differentials and fiscal deficits.¹⁹ This view demonstrates a strong faith in the efficiency of private international markets as arbiters of key international economic relationships, but the faith is misplaced. Exchange rate volatility and misalignment have persisted even though G7 macroeconomic policies have converged around orthodox norms.

The G7 supports the strategy of coordinated intervention to tame exchange rate volatility in principle, arguing that “cooperation in the exchange markets can be a useful and effective means for moderating exchange rate movements that are not driven by fundamental changes in economic conditions or policies”.²⁰ Between 1992 and 1995 the G7 coordinated intervention on a number of occasions to support the dollar against the yen and mark, while in 1998 a dramatic intervention temporarily halted a collapse in the yen’s value. Coordinated intervention often did have the desired impact, despite the fact that the volume of coordinated intervention was modest in comparison to private market flows.²¹ This reflects that fact that traders pay close attention to the signals that coordinated intervention sends regarding government intentions.²² But intervention often came too late to prevent major misalignments, and was sometimes undertaken as a one-shot effort that was not sustained over enough time to have a lasting impact. The G7 also stepped aside from even attempting to deal with exchange rates among the EU countries, as these countries embarked on a regional attempt to manage international market pressures by first stabilizing exchange rates and then creating a single currency.

Concern about exchange rate volatility has generated interest in proposals for a less

flexible exchange rate system. One widely-discussed proposal is to establish target zones for exchange rates and defend them by actively coordinating foreign exchange market intervention and monetary policies.²³ The G7 made a half-hearted move in this direction with the 1987 Louvre accord, but the attempt soon failed because intervention was not consistent enough, because monetary policies were not coordinated closely enough in support of the ranges, and because the G7 countries undermined the credibility of coordinated market intervention by publicly criticizing each other.²⁴ These obstacles to successful exchange rate stabilization are political, not technical. Nevertheless, most G7 finance ministries have become convinced that mechanisms like target zones simply cannot work because the volume of private foreign exchange trading so far exceeds the foreign exchange reserves of central banks. According to the G7 finance ministers, “the instrument of intervention must be used judiciously given its implications for monetary policy and the amount that the authorities can mobilize relative to the size of international capital markets”.²⁵

This belief in government powerlessness is exaggerated. The 1992-93 European exchange rate crises, which had a major impact on official thinking, did demonstrate that massive speculative flows can overwhelm large-scale coordinated intervention. But part of the problem in 1992 was that two currencies under attack — the pound and lira — were clearly overvalued, yet their governments refused to negotiate devaluations. And while the daily volume of foreign exchange trading is enormous, the net volume of open speculative positions is much smaller.²⁶ Some central banks hold enormous foreign currency reserves, yet are unwilling to commit more than a tiny share to the defence of their currencies. The combined foreign exchange reserves of the US and Japan, for example, amounted to \$283 billion in April 1998,²⁷ but the two central banks committed only \$7-10 billion to the defence of the yen, on only one occasion, as that currency tumbled in the spring and summer of 1998. All of this suggests that an important part of the problem is the G7’s self-perception of impotence, rather than impotence in fact.

Another way to deal with market-driven exchange rate instability would be to reestablish some controls on short-term capital flows, reducing the speculative pressures that generate exchange rate volatility and constrain national policy-making autonomy. This approach has gained support in recent years as the costs of unrestrained international capital mobility have become more apparent, especially in the wake of the East Asian financial crises of 1997-98.²⁸ An irony here is that foreign exchange markets are among the freest and most efficient markets anywhere in the world, yet they have failed dismally to have the positive effects on welfare predicted by economic theory. Few mainstream analysts advocate a return to full-fledged capital controls; instead, attention has focused on James Tobin's idea for a small tax on foreign exchange transactions to discourage unwanted currency speculation without blocking more desirable capital movements, such as foreign direct investment or trade financing.²⁹

Despite interest from some G7 heads of government,³⁰ the Tobin tax met very strong opposition in the international financial community and from G7 finance ministers. The latter bluntly dismissed the idea, arguing that the tax could easily be evaded and would prevent countries from capturing welfare gains from international capital flows.³¹ A Tobin tax would be easy to avoid unless it was imposed in every major trading centre — an unlikely scenario, given

opposition from the UK, the US, and offshore financial centres. But the idea that free mobility for financial capital brings great benefits is not supported by empirical evidence. Indeed, it is increasingly being challenged by economists — including even some traditional advocates of free trade.³² The G7 also has not seriously considered another possibility for dampening speculation, that of imposing reserve requirements on financial institutions' speculative holdings of foreign currencies. Such a reserve requirement would add to the cost of betting on a change in the value of a currency, thereby slowing speculative pressures enough to provide time for other measures to be put in place.³³ Since this requirement would be technically similar to the loan-loss reserves that banks are already required to hold, it could be incorporated into the proposals for enhanced prudential regulation of the financial services sector already being promoted by the G7. These characteristics of the G7's approach suggest that it is driven more by ideology than by a careful assessment of costs, benefits, and practicalities.

While the G7 countries have themselves suffered some ill effects from foreign exchange speculation, the worst effects have been borne by emerging market countries such as Mexico in 1994-95, numerous East Asian countries in 1997-98, and Russia and Brazil in 1998. In many of these cases, international financial liberalization combined with weakly-developed or corrupt domestic financial systems to cause major economic crises when investors lost confidence and capital took flight to safe havens such as the US. But in other cases (such as Brazil), governments had been moving in policy directions favoured by international investors and the IMF, yet were still sideswiped by the general collapse of investor confidence in emerging markets. These problems indicate a clear need for stricter political management of short-term capital markets.

However, the G7's response (at the 1995 Halifax summit and again in 1997-98) once again emphasized the solution of bringing government policies more in line with market preferences rather than directly taming international financial markets. Countries in crisis were encouraged to further liberalize capital flows in conjunction with market-oriented domestic restructuring.³⁴ In order to reduce the likelihood of such crises in the future, the G7 called for the development of an "early warning system" in the IMF, and for IMF measures to increase the transparency of national government policies. The G7 finance ministers claimed that "well-informed and well-functioning financial markets are the best line of defence against financial crises",³⁵ despite overwhelming evidence that market players simply fail to respond to information that runs counter to the instincts of the herd.³⁶

Stricter IMF supervision, increased data publication, and more liberal capital markets will expose emerging market economies more fully to the disciplining effects of private international markets, and are therefore best seen as measures to regulate governments, not markets.³⁷ The G7 has called for enhanced cooperation among national and international financial regulators to improve prudential supervision of private financial institutions, but this is intended to protect the health of the financial sector itself, not to mitigate the impact of short-term capital flows and exchange rate volatility on the real economy. The G7's proposals for reform of the international financial architecture included the suggestion that private lenders should bear a larger share of the burden of emergency rescue packages, but to date this has not been done.

The severity of the crises in 1998 revealed that the inadequacies of the G7's approach. Increased transparency and market liberalization had not prevented crises, little progress had been made in strengthening prudential regulation, and increases in IMF funding had not been sufficient to meet increasing demand for ever-larger emergency bailout packages for EMEs. In August 1998, both Malaysia and Russia adopted strict controls to prevent or reduce harmful capital flight, and other EMEs examined less drastic measures such as those that Chile and China had used to insulate themselves from short-term financial market volatility. These developments indicated that if the G7 and IMF were unwilling to support systemic efforts to limit speculative short-term capital flows, many EMEs would do so themselves. In response, some G7 countries (France, Japan, and Canada) and the IMF reluctantly acknowledged that controls on short-term capital flows could be appropriate for countries with weakly developed financial systems, and for countries experiencing an international financial crisis. The United States, however, continued to insist on capital market liberalization, and denied that speculative financial flows had played a significant role in emerging market crises. As noted earlier, US leaders called for coordinated interest rate cuts and fiscal stimulus by the G7 countries to stimulate global demand and pull EMEs out of depression, thereby discouraging them from implementing unilateral capital controls.

Thus, even though attitudes to capital controls had altered slightly by fall 1998, the G7 continued to reject political management of short-term international finance. The reasons included the G7's (and especially the US's) deep ideological commitment to the free flow of capital, opposition from the transnational financial industry, and the technical difficulty of devising controls that would dampen financial speculation without interfering with trade-related capital flows and foreign direct investment. The G7 continued to place faith in better informed and more efficient markets as the way to prevent future emerging market crises, but the strain that increasing demands for bailouts placed on the IMF and World Bank showed that this strategy cannot succeed indefinitely.