

FINANCIAL MELTDOWNS AND EXCHANGE-RATE REGIMES

By Steve H. Hanke
The Johns Hopkins University
hanke@jhuvms.hcf.jhu.edu

Prepared for the Cato Institute's 16th Annual Monetary Conference cosponsored with *The Economist*, October 22, 1998, Washington, D.C.

The dramatic events in Asia and Russia have generated a torrent of commentary about exchange rates, hot money and exchange controls. As someone whose views about exchange rates in Asia have been vindicated (Review Editorial, "Monetary Mischief," *Far Eastern Economic Review*, July 2, 1998) and who predicted that the ruble would collapse by midyear (S.H. Hanke, "Is the Ruble Next?" *Forbes*, March 9, 1998), I offer my thoughts as to why most of the commentary has either been half-baked or dead wrong. Indeed, the international chattering classes have misdiagnosed the patient and, in consequence, prescribed the wrong medicine.

Exchange-Rate Regimes

There are three types of exchange-rate regimes: floating, fixed and pegged rates. Each type has different characteristics and generates different results. Although floating and fixed rates appear to be dissimilar, they are members of the same family. Both are free-market mechanisms for international payments. With a floating rate, a monetary authority sets a monetary policy, but has no exchange-rate policy--the exchange rate is on autopilot. In consequence, the monetary base is determined domestically by a monetary authority. With a fixed rate, on the other hand, a monetary authority sets the exchange rate, but has no monetary policy--monetary policy is on autopilot. In consequence, under a fixed-rate regime, the monetary base is determined by the balance of payments. In other words, when a country's official net foreign reserves increase, its monetary base increases and vice versa. With both of these free-market exchange rate mechanisms, there cannot be conflicts between exchange-rate and monetary policies, and consequently, balance of payment crises cannot occur. Indeed, under floating and fixed-rate regimes, market forces act to automatically rebalance financial flows and avert balance of payments crises.

While both floating and fixed-rate regimes are equally desirable in principle, it must be stressed that floating rates, unlike fixed rates, do not perform well in developing countries because these countries usually have weak monetary authorities and histories of monetary instability. For recent dramatic examples, we have to look no further than Thailand, Korea, Indonesia and Russia. Fixed and pegged rates appear to be the same. However, they are fundamentally different. Pegged rates are not free-market mechanisms for international payments. Pegged rates, such as those that were employed throughout most of Asia and in Russia before the recent currency crises, require a monetary authority to manage both the exchange rate and monetary policy. With a pegged rate, the monetary base contains both domestic and foreign components. Unlike floating and fixed rates, pegged rates invariably result in conflicts between exchange rate and monetary

policies. For example, when capital inflows become "excessive" under a pegged system, a monetary authority often attempts to sterilize the ensuing increase in the foreign component of the monetary base by reducing the domestic component of the monetary base. And when outflows become "excessive," an authority attempts to offset the decrease in the foreign component of the base with an increase in the domestic component of the monetary base. Balance of payments crises erupt as a monetary authority begins to offset more and more of the reduction in the foreign component of the monetary base with domestically created base money. When this occurs, it is only a matter of time before currency speculators spot the contradictions between exchange rate and monetary policies and force a devaluation. This is what happened in Europe's Exchange Rate Mechanism in 1992 and 1993 and in Mexico and Turkey in 1994. The same story repeated itself in the summer of 1997 in Thailand and in the other Asian countries with pegged exchange rates and in Russia this fall. (See Table 1 for a summary of the main characteristics and results anticipated with floating, fixed and pegged exchange rates.)

Hot Money and Exchange Controls

Hot money flows are principally associated with pegged exchange rates. Most analysts have misdiagnosed the hot money problem because they have failed to appreciate this all-important linkage. Consequently, they have prescribed exchange controls as a cure-all to cool off the hot money. That prescription treats the symptoms. Indeed, it fails to treat the disease, which is pegged exchange rates. Until pegged rates are abandoned, there will be volatile hot money flows and calls to cool the hot money with exchange controls.

Professor Paul Krugman of the Massachusetts Institute of Technology ("Saving Asia, It's Time To Get Radical," *Fortune*, September 7, 1998) is the most notable promoter of exchange controls. Malaysia's mercurial prime minister, Dr. Mahathir Mohamad, has taken Krugman's bait and imposed the following draconian controls:

- The Malaysian ringgit was pegged to the U.S. dollar at a rate of RM 3.8 per dollar.
- All export and import settlements must be done in foreign currencies.
- Malaysians will need approval to invest more than RM 10,000 abroad.
- Malaysians and foreigners who have ringgit accounts in Singapore and elsewhere have one month to repatriate them to Malaysia. Incidentally, there is an estimated RM100 million cash held overseas and RM25 billion in offshore accounts.
- From October 1, travelers into and out of Malaysia may not carry more than RM 1,000. Visitors will not be allowed to take out more foreign currency than they brought in.
- In an effort to reduce smuggling, RM 500 and RM1000 notes will be taken out of circulation.

Like all pyromaniacs, Prof. Krugman has now washed his hands of this dastardly deed. Perhaps this is the most devastating critique of controls. But there is more.

Currency convertibility is a simple concept. Essentially it means residents and nonresidents are able to exchange domestic currency for foreign currency. However, there are many degrees of convertibility, with each denoting the extent to which governments impose controls on the exchange and use of currency.

The pedigree of exchange controls can be traced back to Plato, the father of statism. Inspired by Sparta of Lycurgus, Plato embraced the idea of an inconvertible currency as a means to preserve the autonomy of the state from outside interference. It is no wonder therefore, that the so-called Red-Brown (communist-fascist) coalition in the Russian Duma has, in recent weeks, rallied around the idea of exchange controls and an inconvertible ruble. This also explains why the leadership in Beijing finds the idea so user friendly.

The temptation to turn to exchange controls in the face of disruption caused by “hot money” flows is hardly new. Tsar Nicholas II first pioneered limitations on convertibility in modern times, ordering the State Bank of Russia to introduce, in 1905-06, a limited form of exchange control to discourage speculative purchases of foreign exchange. The bank did so by refusing to sell foreign exchange, except where it could be shown that it was required to buy imported goods; otherwise, foreign exchange was limited to 50,000 German Marks per person. The Tsar’s rationale for exchange controls was that of limiting hot money flows, so that foreign reserves and the exchange rate could be maintained. The more things change, the more they remain the same.

But before more politicians come under the spell of exchange controls, they should ponder on the following footnote in Nobel laureate Friedrich von Hayek’s 1944 classic, *The Road to Serfdom*:

The extent of the control over all life that economic control confers is nowhere better illustrated than in the field of foreign exchanges. Nothing would at first seem to affect private life less than a state control of the dealings in foreign exchange, and most people will regard its introduction with complete indifference. Yet the experience of most Continental countries has taught thoughtful people to regard this step as the decisive advance on the path to totalitarianism and the suppression of individual liberty. It is, in fact, the complete delivery of the individual to the tyranny of the state, the final suppression of all means of escape--not merely for the rich, but for everybody.

Hayek’s message about convertibility has regrettably been overlooked by many contemporary economists. Exchange controls are nothing more than a ring fence within which governments can expropriate their subjects’ property. Open exchange and capital markets in fact protect the individual from exaction because governments must reckon with the possibility of capital flight.

From this it follows that the imposition of exchange controls leads to an instantaneous reduction in the wealth of the country, because all assets decline in value. To see why, let's review how assets are priced.

The value of any asset is the sum of the expected future installments of income it generates discounted to present value. For example, the price of a stock represents the value to the investor now of his share of the company's future profits, whether issued as dividends or reinvested. The present value of future income is calculated using an appropriate interest rate that is adjusted for the various risks that the income may not materialize.

When convertibility is restricted, risk increases, and so the risk-adjusted interest rate employed to value assets is higher than it would be with full convertibility. That is because property is held hostage and subject to a potential ransom through expropriation. As a result investors are willing to pay less for each dollar of prospective income and the value of property is less than it would be with full convertibility.

This, incidentally, is the case, even when convertibility is allowed for profit remittances. With less than full convertibility, there is still a danger the government will confiscate property without compensation. This explains why foreign investors are less willing to invest new money in a country with such controls, even with guarantees on profit remittances.

So investors become justifiably nervous when it seems a government is considering imposition of exchange controls. At this point, settled money becomes "hot" and capital flight occurs. Asset owners liquidate their property and get out while the getting is good. Contrary to popular wisdom, restrictions on convertibility do not retard capital flight: they promote it.

This type of capital flight (and dollarization) has been occurring on a grand scale in capital-starved Russia. Indeed, Russians swapped \$13 billion worth of rubles for greenbacks in 1997, a year in which the dollar-ruble rate was stable and inflation was falling rapidly. This dollarization amounted to a capital export that exceeded all capital imports to Russia that year. The actions of the Russian people in 1997 indicate that, among other things, they anticipated the possibility of the imposition exchange controls.

Restrictions on convertibility also promote other noxious activities. For example, if capital account convertibility is restricted or limited and convertibility on the current account is allowed, a two-tier currency market will be either formally or informally established. In that case, the "investment currency" will trade at a premium over the price of the relevant foreign currency on the official market for current account transactions. With two prices for the same currency, there are profits to be derived from having capital account transaction "reclassified" as current account transactions. That ad hoc reclassification can usually be bought by crony capitalists, for a price.

Full convertibility is the only guarantee that protects people's rights to what belongs to them. Even if governments are not compelled by arguments on the grounds of freedom, the prospect of seeing every asset in the country suddenly lose value as a result of exchange controls should give them pause.

Exchange Rates for the New Millennium

As we enter the 21st century, globalization (the liberalization of financial and trade flows) is threatened. Volatile hot money flows are identified as the problem and exchange controls the remedy. This prescription, which is based on a wrongheaded diagnosis, will lead to monetary nationalism and the type of chaos the world encountered during the interwar years. The only way to avoid such a disaster is for developing countries to unify their currencies with stronger ones via fixed exchange rates supported by currency board monetary constitutions.

This conclusion troubles some analysts who fret about the inflexibility of fixed exchange rates and currency boards. *The Economist* summarized those sentiments in a piece, "The Great Escape," which appeared in the May 3, 1997 issue. That article asserted: that currency board systems cannot cope with external shocks; that they are vulnerable to surges in inflation triggered by capital inflows; and that with limited lender of last resort capacities, they cannot deal effectively with financial emergencies.

The evidence does not support these oft-repeated assertions, however. Let's look at the data from 98 developing countries during the period 1950-1993 and separate it into two categories: countries that have pegged exchange rates and those that have fixed rates. The latter category includes countries with currency boards, monetary institutes, and those that rely solely on foreign currency. On average, the growth rates, measured in terms of GDP per capita, in countries with fixed exchange rates were 54 percent greater than those with pegged exchange rates. Furthermore, the variability of those growth rates (as measured by their standard deviations) was virtually identical, indicating that the lack of discretionary monetary policy with fixed exchange rates did not result in any greater incidence or vulnerability to external economic shocks. As for inflation, fixed rates have proved far superior to pegged rates, with average inflation rates being 4.9 times higher in countries with pegged rates and 4.2 times more variable. In terms of budget deficits as a percent of GDP, those countries utilizing pegged rates had deficits that on average were 65 percent larger and 1.4 times more variable. Finally, countries with fixed rates experienced fewer financial emergencies.

Until recently, most economists have refused to consider currency boards or to look at the facts. Many have just declared that fixed rates are "inappropriate" or claimed that the facts are "erroneous." There's nothing new here. Indeed, Michael Polanyi concluded in his 1958 book, *Personal Knowledge*, that it is "the normal practice of scientists to ignore evidence which appears incompatible with the accepted system of scientific knowledge." With the failure of pegged and floating rates in Asia and Russia, the tide has begun to shift (see, for example, Stanley Fischer, "Reforming World Finance: Lessons from a Crisis," *The Economist*, October 3, 1998). This shift

is welcome and has left me feeling a bit like Winston Churchill on his return from the Boar War, when he remarked that “Nothing in life is so exhilarating as to be shot at without success.”

Table 1
Exchange Rate Regimes

<u>Type of Regime</u>	<u>Exchange Rate Policy</u>	<u>Monetary Policy</u>	<u>Source of Monetary Base</u>	<u>Conflicts Between Exchange Rate and Monetary Policy</u>	<u>Balance-of-Payments Crisis</u>
Floating Rate(1)	No	Yes	Domestic	No	No
Fixed Rate(2)	Yes	No	Foreign	No	No
Pegged Rate(3)	Yes	Yes	Domestic and Foreign	Yes	Yes

Notes:

- (1) Floating rates are employed in most developed countries.
- (2) Fixed rates are employed in several developing countries or regions: Hong Kong (1983), Argentina (1991), Estonia (1992), Lithuania (1994), Bulgaria (1997), and Bosnia (1998).
- (3) Pegged rates are employed in most developing countries and also among the countries that are members of Europe’s Exchange Rate Mechanism.

Source: Steve H. Hanke. “How to Establish Monetary Stability in Asia.” *The Cato Journal*, Vol. 17, No. 3, Winter 1998.