Comment on the Wyplosz/Eichengreen Paper

Coen Voormeulen

The paper by Wyplosz and Eichengreen is intellectually challenging and to a considerable extent appealing. It almost convinced me that the introduction of restrictions on capital flows in general might not be a bad idea after all. Yet, after giving it some further thought, I came to an old conclusion: restrictions on outflows will not be a useful device. Sure, markets do react occasionally in an unsatisfactory way - I'll come back to that later on - but restrictions on capital outflows will not make markets function better. On the contrary, they make matters worse.

What the paper says, in fact, is that exchange rate policy is too difficult. So you'd better get rid of it, either by operating a fully flexible system or by total monetary unification. The paper acknowledges that the search for monetary unification takes time. Meanwhile, countries should give themselves some breathing space by the introduction of a small tax or minimum holding period on foreign exchange transactions. Rightly, it is said that economists are instinctively sceptical. I will try to explain this instinct.

A Transactions Tax Delays a Crisis

First of all, Wyplosz and Eichengreen put the scepticism into 'perspective': they note that economists who are sceptical of capital restrictions do not, in general, evince the same attitude towards, for instance, prudential supervision. I would argue that this is something different. Prudential supervision is meant to protect the proper functioning of the banking system and its clients. Because of the interlinkages between banks, bank failures bear the risk of spreading to other banks. In the case of investors, this is not the case. What can be considered a threat is that a country, confronted with a sudden and considerable outflow of capital, would be forced to undergo such excessive adjustment that its domestic economy would be unduly hurt. One could argue that preventing the destruction of a particular economy is at least as good a reason for supervision as the protection of the banking system.

In principle, this might be true. But the introduction of capital restrictions, for instance in the form of a transaction tax, as a means to prevent that risk, implies that one considers such a tax as an effective instrument for preventing undue speculation. That, I think, it is not.

We all know the standard objections: the allocation of capital would be disturbed, the tax would have to be implemented worldwide, there will always be possibilities of circumvention, etc. Although justified in themselves, I will leave these objections aside for the moment.

Let us suppose that the transaction tax *is* effective and that it *does* reduce the number of transactions. What would be the effect? Would it decrease volatility? I am not sure. It might. But reducing the number of transactions would make markets thinner, so that every single transaction would - other things being equal - have a stronger effect on the exchange rate.

Even if short-term fluctuations are reduced, I still feel we are addressing the wrong problem. The main problem is medium-term: misalignments built up over time by some form of myopia of the markets. Then, at some point in time, markets enforce a crisis-like correction when they finally take a realistic view of the underlying economic problems of a country.

The Wyplosz-Eichengreen paper correctly points out that up to a certain level markets can be prevented from acting on expected devaluations as the result of a transaction tax. But my expectation would be that, as long as the exchange rate remains unchanged, the underlying problems (large current account deficits, undue expansionary policies, etc.) would continue as well. At a certain point in time, the gains an investor could expect from selling a particular currency have increased to such an extent that the tax will no longer be sufficient to prevent speculation against the currency. In that case, what the tax ultimately does is to delay the correction of the exchange rate. Proponents of such a tax might argue that this delay would give the authorities a breathing space enabling them to take corrective measures. I would argue that it is far more realistic to expect that this delay would imply the continuation of inappropriate policies. It is hard to believe that the tax - reducing as it does the urgency of correction - is an incentive for governments to take corrective action. Therefore, a transaction tax would delay a currency crisis, thus making it even more severe when it finally erupts.

This reasoning might be countered by the argument that crises also occur in situations where fundamentals are strong. I don't believe this. France is often cited as a country where fundamentals did not diverge from those in Germany, whereas the French franc still came under heavy pressure. I would not contest the fact that the traditional fundamentals of France were sound. Yet unemployment was rising, and markets doubted whether the French authorities would be prepared to pursue strict enough policies to keep the parity with the German mark unchanged. Whether markets were right in this perception is a question I cannot answer, but it is hard to believe that investors based this perception on anything other than what they thought to be likely, probably based on past experience.

By the way, if anything, the pressure on the franc did strengthen French policies. Thus the crisis did have beneficial effects. This is an important point. If we look back, the exchange rates of the lira and of sterling were overvalued in 1992. A correction *had* to take place. The challenge should have been to ensure an early correction rather than delaying it. Therefore, the beneficial disciplinary effects of speculation, or hedging, or arbitrage, or whatever term one wishes to use, would be reduced by a transaction tax, while, if anything, these beneficial effects should be strengthened.

Four Alternative Measures

How could this strengthening take place? Let me review some possible measures, although none of them will give any hard and fast guarantees.

The *first* that is now often mentioned is a better provision of (statistical) information - the IMF is working on a proposal in this area. To some extent this may be of help; markets would be better able to assess the underlying situation in a country, thus preventing excessive capital inflows, and authorities may feel forced to anticipate the possible reaction of the markets by taking appropriate measures.

A *second,* and related measure would be the publication by the IMF of its Article IV reports, in particular its staff appraisals. The view of the Fund can provide markets with a sound basis for their judgements. Admittedly, this would also involve a risk. The frankness of the discussions between Fund staff and the monetary and political authorities might suffer, and a critical assessment by the Fund might even trigger exchange rate problems. But the risk is well worth taking.

A *third* possibility would be to try to diminish moral hazard, particularly for creditors, by providing an alternative to bail-outs. It is clear that, in the case of Mexico, investors strongly believed that Mexico would be bailed out, and they were right. Perhaps with other countries, investors would have felt less comfortable, but any reduction in expectations of a bail-out would be helpful.

A possible alternative to a bail-out is, of course, a situation where the international community would refrain from action. This would, however, entail heavy costs to the countries involved and markets might consider this unrealistic. Another alternative would be a work-out arrangement, as is now being discussed within the G-10. Making such a work-out a very formal procedure is probably not realistic as this would involve too many legal difficulties, but a somewhat more informal approach could be helpful. One could envisage that the international community would make clear - in some way - that a financial package would not in general be extended. Then, a country faced with a liquidity shortage may have to declare a temporary standstill after which debt restructuring, also extending to bonds, would be negotiated. Attached to such a restructuring could be a quick disbursement of IMF credit, possibly in the framework of the newly established

Emergency Financing Mechanism, and in certain instances the credit could even be of exceptional size.

Such a package would entail a substantial number of problems, and it might even be seen as a bail-out as well. However, the essential difference is that a work-out would have as its inevitable complement some kind of debt restructuring, thus ensuring that creditors accept a loss.

There is a *fourth* possibility for addressing large capital inflows into countries experiencing undue difficulties in handling their monetary policies in those circumstances. I am referring, with some reluctance, to capital restrictions on inflows. In the Mexican case it was clear that the initial level of capital inflow was excessive; it contributed to an increasing current account deficit for which no correction was in sight. And Ariel Buira mentions that the inflow of money went hand in hand with a 'rapid growth of non-performing loans', clearly indicating that the level of inflow was unsustainable.

- There are several reasons why capital inflow restrictions are less problematic than restrictions on outflows.
- The mouse-trap argument (reluctance to invest in a country for fear of the impossibility to get out again) is not applicable, so in that sense such restrictions do not hurt the long-term development of an economy.
- These restrictions might be seen as a sign of strength rather than of weakness, as they may be perceived as an element of sound monetary policies.
- Circumventing the restrictions is unlikely, because there will undoubtedly be a second-best investment for an investor with comparable returns, eliminating the incentive for circumvention.

For developed economies restrictions on inflows do not constitute a realistic device. There, they are also less needed. Capital markets are more mature and sterilisation will be easier. Likewise, the other suggestions which I just made would probably not help to prevent possible crises in Western Europe. In the ERM the best way of preventing a currency crisis from re-emerging is, in the reasoning of the Wyplosz-Eichengreen paper, by attuning policies to convergence, thus paving the way for monetary union. A narrowing of the present wide bands for countries not showing enough convergence is probably unwise, but for countries where fundamentals are in line with those of the anchor currency, stabilising the exchange rate is by no means impossible - as has been proved by the Netherlands and Austria. But it requires an unlimited preparedness to defend the currency, not (only) by intervention, but by appropriate and early adjustments of domestic interest rate levels. In that sense one could argue that these countries could just as well form a monetary union. In principle, they could. And they will, but within the framework of the Maastricht Treaty. Implementing the Treaty will be the best way to make sure that currency crises within Europe will no longer occur.