Floor Discussion of the Wyplosz/Eichengreen Paper

Johannes Witteveen observed that Charles Wyplosz had not mentioned two major problems of the current international monetary system. "First, I think that the climate in which these volatile capital movements originate and in which this overshooting happens is an inflationary climate in which capital is often financed without reducing the supply of money in the capital-exporting countries. That is why these flows so easily reach such high levels. There is a major problem confronting the world economy as a whole, namely how to develop a better management of total international liquidity. The other problem which Mr. Wyplosz fails to see or denies the importance of is these very big fluctuations in real effective exchange rates of the major countries. You say that this is not important to the United States. I doubt that. But it is certainly of enormous importance for Japan. Every day we read about the enormous difficulty this is causing the Japanese economy. I think such changes in real exchange rates have a very deep effect on the real economy and cause major disturbances. The problem is not only what to do with exchange rates in smaller open economies, but also in major economies."

Regarding the solution to these major problems, Witteveen referred to a paper he had presented to the Dutch Economic Association in December 1994 on 'Fifty Years After Bretton Woods'. "In the first place, I suggested in that talk that it would be a good idea if the international community - the IMF, the BIS, the central banks of the major countries - surveyed the developments in international liquidity from time to time, and assessed what the sources of increases in liquidity had been. If the creation of international liquidity had been excessive (which is often the case), one should then see what could be done to manage it. Now, as we all know, one of the major sources of international liquidity has been and still is the US balance of payments deficits, including capital exports from the United States to Mexico and other emerging economies. It is a major flaw of the dollar standard that US deficits are paid in dollars which somehow have to be held by other central banks or commercial banks. So, to me it seems a rather logical idea (at least if the United States sees the importance of a little better management of the dollar rate, which ought to be the responsibility of a reserve currency country) that, if the exchange rate of the dollar reaches a certain level where it becomes clear that there is a deficit which is bringing the exchange rate up or down (I think of approaching the wider band that the Bretton Woods Commission had in mind), then measures are taken to attract capital flows which could finance the US deficit in a better way. I mean, not finance the US deficit just by forcing central banks

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

to accumulate dollars, but by attracting money on world capital markets in non-dollar currencies, thus making it clear that the US administration would really work to stabilise the dollar within that wider band. At the same time, of course, the United States would then be looking at the possibility of adjusting its policies. This would yield both an instrument for better management of international liquidities and for greater stability in real exchange rates. Both issues are certainly a very serious problem in the present monetary system, or non-system as it perhaps could better be called.

I know that in the past, when this idea was brought up (of letting the United States borrow in other currencies), it was suggested that this would undermine the credibility of the dollar. It seems to me that after what happened recently with this enormous fall of the dollar, a stabilisation of the exchange rate of the dollar within reasonable bands as proposed by me and others would rather restore credibility.

These ideas may go beyond what we are discussing today. I nevertheless thought that I might put them on the table."

Peter Kenen saw major difficulties with some of the proposals in the Wyplosz/Eichengreen paper.

"First a small point, Charles. The Bretton Woods Committee did not propose a return to fixed but adjustable exchange rates. As one who negotiated for hours the language of that report, I can tell you that what we proposed was an 'eventual adoption of a system of flexible currency bands'. Managed floating? Maybe, I don't know. But certainly not 'fixed but adjustable exchange rates'.

Second, there is the rather coy footnote 20 in your paper on the practical difficulties of administering a foreign exchange tax. Let me point out that it has not only to be administered globally, I mean everywhere, including the Cayman Islands, but it has to be administered in respect of spot, forward and swap transactions, and futures and options. If not, you have a problem. You and I will cross swords on this at another place and another time and over a different basic issue. I have been told by many people that if one imposes a tax much in excess of 5 basis points, the incentive to invent synthetic currency transactions through the options market will be enormous, and therefore evasive of such a tax.

Finally, on the question of capital controls, in particular the idea that you can limit volatility by deposit requirements, I'm sympathetic to the idea of using those to limit inflows, but as I have said before, I don't think you can use them to prevent massive outflows, except in so far as you can use them to prevent financial institutions from going short the domestic currency or financing short positions by others. You cannot use these controls to prevent non-banks, including foreigners, from liquidating existing long positions in domestic currency. Would you say to a holder of Tesobonos: 'If you choose to sell them, you must then deposit a portion of the proceeds with the Central Bank in Mexico before you can sell the peso proceeds for dollars?' What about a non-bank holder of pesos who simply

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

takes his bank account and crosses the foreign exchange market? The leaks here are enormous. I grant that controls can prevent very large transactions by financial institutions and very large-scale borrowing from the banking system. But it would be harder to track and control the very large number of transactions by nonfinancial institutions and individuals."

Stephany Griffith-Jones answered Charles Wyplosz' question why careful regulation of domestic banking systems is perfectly acceptable, whereas any kind of similar regulation internationally is not accepted. "Part of the answer is that - and if one reads Kindleberger again one can see that - there have been a lot of very costly domestic banking crises, and people have paid the cost, again and again. As a result, they decided that the least bad option was to have the kind of arrangements that we now have on the domestic front. And similarly, I would argue that a lot of the international regulation that now exists on banks was imposed after problems arose, after the Mexican crisis, after the Herstatt crisis. Regulation tends to move after a crisis, after the costs have been borne. I think it would be nice if we could learn from history - of course, nobody does - and sometimes try and have developments on the regulation front to stop costly crises before they happen. But even if one follows this hypothesis, there may be a case, now that we have had our first crisis of the 21st century as Camdessus said, for some regulation or some other kinds of measures, like those discussed by Charles Wyplosz, that would diminish these risks."

Charles Siegman was struck by the notion in the Wyplosz/Eichengreen paper that all the countries that are potentially subject to the powerful impact of surges of capital should rely on the development of a currency union.

"It isn't clear from the example in the paper whether Mexico should join the United States eventually or some other currency union. And if the geographical location is not the justification for committing itself to a union, e.g. Malaysia or Saudi Arabia, where should the country go? There is a whole range of countries that are subject to exchange market fluctuations. One would have to start identifying what the natural location for them would be.

Good policies will generate stability in economies and prevent those countries from experiencing serious payments problems. We have not sufficiently addressed the problem of how countries can create the self-discipline to pursue policies that are good for themselves and eventually good for the collective system. That has been the constant battle which the IMF has had with its clients, and that the G-7 has had in its dialogues. I do not have the answer. But I think that focusing attention on sound monetary and fiscal policies in the context of global cyclical developments is not to be dismissed. That is the best preventive, both for internal impacts of surges - you won't get them - and outflows that are disruptive, and even for tackling the fluctuations that Mr. Witteveen is concerned about.

The other issue which I think one has to start mentioning at this point is that of self-discipline, not just with regard to policies, but also with regard to official

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

borrowing. Official borrowing is something which is in the control of the governments. It is not regulation, it is a matter of not being tempted to supplement reserves to protect a fixed exchange rate which may not be able to be protected over time, or avoiding the domestic policy adjustments that are inevitable. That is not regulation, it is a matter of not going to the market and issuing new government securities. Some European countries in the 1950s and 1960s - Italy and others - utilised the international markets to supplement reserves aggressively, and typically got into trouble by over-borrowing. So it is not just limited to the case of Mexico.

I will not comment on Mr. Witteveen's suggestion on the role of the dollar and the various policies, but I think there's an undertone that there are national authorities who are forced to hold reserve currencies. They are not obliged to do so. The role of the dollar as an international currency has been selected by the market. The United States did not impose that role. The US current account deficit is large and the United States should pursue policies that would bring it down for its own good. Eventually, that will be good for the global economy. I appreciate the suggestions of adjusting the various policies in order to create more global stability. It is certainly in our collective interest. The United States is not immune; it is not that only other countries must have good policies - the US needs them as well."

Bernd Goos reacted to Siegman's last remark about the 'free will' of other countries and banks to hold US dollars. "I don't think it is as simple as that - that other countries are holding the dollar because they like to. After all, the dollar is the leading currency, and if the dollar declines because of huge fiscal and current account deficits in the United States, and other currencies correspondingly appreciate against the dollar, it has of course an impact on the economy of these other countries. So you are not totally free to buy or not to buy the dollar. I think the Japanese behaviour to some extent reflected this economic consequence."

Reply by Charles Wyplosz

"Let me go back to where I left off, which was asking for better solutions. I was not surprised that most people did not like the ideas put forward in our paper. One of the solutions I heard was that of Bill White, who essentially said 'All is fine'. Countries which have floating exchange rates are very happy with them. Even Krugman sees no problem with real exchange rate swings, so that's fine. But I also heard an attack from the opposite side, Mr. Witteveen saying 'you should worry about dollar undervaluation and yen overvaluation, as this is a serious problem'. Yes, I agree with you that it is a serious problem. I was trying to go a little bit in the direction of where I expected trouble with Bill White saying 'It's fine, it's fine'. I think when you say it's fine, you at least should concede that this is not a unanimous view, no matter what Paul Krugman says. Some people who are not

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

that unreasonable think it is a problem and it is creating difficulties, so I don't think that is the solution.

The other solution came from Charles Siegman, who was saying that 'good sound monetary policies' would do it, and the self-discipline by borrowers - that's fine. I don't know what kind of politicians you talk to. The ones I see operating, including in the US Congress - maybe with the exception of the Netherlands, which has managed to have a fixed exchange rate for a long, long time - are not the ones I would rely upon to pursue a sound monetary policy and to impose upon themselves the self-discipline needed. If you admit that politicians are prone to making mistakes, then again we return to the question of how much of a price we want countries to pay for the policy mistakes made by politicians. And we can go back to Mexico. We had a long discussion this morning about whether there was a policy mistake and if so, how big it was. I think the agreement was that there was some policy mistake, but nothing really huge. The price paid by Mexico for this policy mistake has been terrible. So it is not enough to say, 'yes policy mistakes happen now and again but let's just educate the politicians'. We have to accept that politicians make mistakes, or that markets believe that politicians make mistakes. And that is enough to create fairly awful situations.

My discussant mentioned France, and the attacks on the franc as an example. Perhaps something which has not been explained about self-fulfilling crises is that it is a very subtle concept. It says that when there is an attack, for good or bad reasons, governments need to have the resolve to resist the attack and that is hard enough. It is already hard enough to have politicians with good policies. When an exchange rate crisis occurs for reasons that may or may not be justified, it becomes harder to have resolve. When the market starts running really quickly and the reserves are being drained and the interest rates have to be raised to a fairly high level, it is hard to do that. And if the attack is of the kind we had in Mexico, which was completely overwhelming, beyond the ability of any central bank in the world to manage, it just becomes impossible. And that is the idea of self-fulfilling attacks - attacks which may or may not be justifiable are just overwhelming, and even if you have good politicians but bad luck, bad expectations, when something goes wrong or the markets rightly discover that the politicians are not the angels we expect them to be, then we can have these kind of attacks. (The Netherlands is the exception in this case.) The costs of these things are very high. So the idea of a self-fulfilling attack is something that requires deep thinking: it happens because people believe that it will happen.

Let me now turn to the point raised by Bill White that in the end international financial markets are regulated indirectly. What I do not see on the exchange rate market is what we see in many markets, namely the circuit breakers. When the markets start going crazy, we stop the batterings in Wall Street and people are told to go and have a drink and think it over. If the peso or pound sterling

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org

plummet within the span of minutes, nobody arises to say: 'let's stop and think about it'. That's the big difference.

There was an argument earlier about why should we care about international financial markets. It is said that we need to protect the domestic markets for good reasons. But I would argue that in the game on the international financial markets, the stakes are much higher. These are policies, not just a few investors who take their risk and may lose. It is a whole policy setting that goes down the drain, which is far more dangerous. At stake in the Mexican crisis was not only whether the Mexican government could survive, and not only whether Mexico would stay the course of liberalising its goods market and financial market - it was whether all of Latin America would stop taking Mexico as an example. So the stakes on the international financial markets are much higher in my view than the stakes on the domestic financial markets."

From: Can Currency Crises Be Prevented or Better Managed?: Lessons from Mexico
FONDAD, The Hague, 1996, www.fondad.org