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"Right" Prices for Interest and Exchange Rates

Roberto Frenkel

Ricardo Ffrench-Davis presents a critical appraisal of the reforms of the Washington Consensus. He criticises the reforms from two perspectives. On the one hand, he shows the results of their actual implementation. The outcome is not only much poorer than expected and announced by their promoters, but in important aspects, such as employment and income distribution, the reforms led to a deterioration. On the other hand, the author points to the lack of realism of the theoretical foundations of the reforms, in particular the assumption of a complete and well-behaved market system, both at the domestic and international levels.

The author links the two critical perspectives and argues that the actual results are a consequence of the design of the reforms because they were erroneously founded and consequently miss-conceived. This is an important point. A mere acknowledgement of the negative results is not enough to know what has happened and what should be done next. After all, facts are facts and cannot be denied. The important point lies in determining the causes of those results. As the title "Reforming the Reforms" indicates, the author intends to differentiate his criticism from the line of reasoning that calls for another sequence of reforms, in which new generations of reforms should follow the first generation. According to this line of reasoning, the reforms were only incomplete and should be completed by other reforms in a sequential linear way. Opposing this view, the author tells us that the reforms were erroneously founded and, therefore, he calls for a reform of the first-generation reforms.

I agree with the main points of the author and will focus my comments on the macroeconomic policy regimes. As Ricardo correctly

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points out, while the Washington Consensus reforms intended to generate the "right" prices, they failed dramatically to do so with regard to two crucial prices: the real exchange rate and the real interest rate.

Misalignment of the Real Interest Rate

The misalignment of the real interest rate has been an unexpected result of the financial globalisation. The liberalisation and opening of the domestic financial market was supposed to lead the developing economies to integration with the international financial markets. The idea was that local real interest rates of the newly integrated domestic financial markets would converge to the developed countries' real interest rates. This has not happened. Actually, the process has developed into a segmented integration in which the real interest rate in the emerging markets is systematically higher than in the developed countries. Country risk premiums have not shown a declining trend. Behind this fact lies not only the imperfection of the international financial market – every financial market is imperfect – but the lack, at the international level, of most of the institutions that improve the working of the financial systems at the national levels. Institutions that the international financial market is missing are, for instance, a lender of last resort, bankruptcy laws and prudential regulations. Some steps towards the development of international institutions were taken in the last quarter of the nineties, but this process was turned back more recently. The existence of widely diverging views about the functioning of international financial markets seems to inhibit initiatives in this crucial area.

The worst distortions in real interest rates in developing countries have usually been related to the misalignment of the real exchange rate. Appreciated real exchange rates led to unsustainable balance of payments and external debt trends. Very high interest rates resulted from those trends pushed by high country risk premiums or induced by monetary policies that aimed to attract capital flows.

Revitalise the Competitive and Stable Exchange Rate Regime

The reforms disregarded any concern about the real exchange rate. This is a curious point, in some sense, because "achieving a competitive exchange rate" was one of the ten principles presented by John Williamson in his famous baptism of the Washington Consensus.

In the mid-seventies, when the process of financial globalisation was beginning, the idea that the real exchange rate should be competitive and stable was broadly shared. This consensus tended to dilute afterwards, eroded by the emergence of high inflation processes in Latin America and by the growing influence of the "monetary approach to the balance of payments". The idea that financial globalisation would remove the balance of payments constraints on growth gained momentum. Consequently, the exchange rate policy could neglect real and balance of payments targets and be oriented to the control of inflation. The macroeconomic policies of the so-called Southern Cone experiments in liberalisation and opening – then supported by the IMF – were the first implementation of those ideas.

The competitive exchange rate regained a priority place in the macroeconomic policy agenda in the mid-eighties, helped by the failures and consequent crises of the Southern Cone experiments and by the resurgence of the external constraint in Latin America. But when capital flows boomed again in the early nineties, the notion of competitive exchange rates vanished.

The IMF supported the full opening of the capital account and the fixed exchange rate regimes adopted by the biggest countries in the Latin American region. Without capital account regulations, monetary policy can hardly play any significant preventive role when capital inflows are booming. In spite of this, the orthodox view showed no concern about the possibility of crises in the first booming phase of the nineties. The Mexican crisis showed that the lack of concern was unjustified.

From then on, the orthodox view and the IMF adopted a preference for floating exchange rate regimes. However, the IMF continued its intellectual and financial support to Brazil and Argentina, which continued operating with full capital account opening and fixed exchange rate regimes. The concern about the possibility of a crisis increased in these cases, but the preventive role was ascribed to the monetary policy: contractive policies in the case of Brazil, and the "currency board" rules in the case of Argentina.

The adoption of pure floating exchange rate regimes was the main change in the orthodox view in the nineties. The change pointed exclusively to the prevention of crisis of the kind experienced under fixed exchange rate regimes. But the change was minimal with respect to the full capital account opening and the fixed exchange rate regimes previously supported. There was no evaluation of the policy regimes that allowed some countries to participate in the financial globalisation process without exposing themselves to high vulnerability and without suffering crises. It was diagnosed that the fixed exchange rate was incompatible with capital flow volatility, and the minimal changes congruent with the orthodox perspective were adopted. The newly adopted regime has been conceived with a defensive attitude in order to preserve the full financial opening when the volatility of capital flows became apparent.

In a pure floating exchange rate regime, there is no exchange rate policy. Monetary policy is isolated from the balance of payments and focused on internal targets. According to the orthodox and IMF perspectives, monetary policy should focus exclusively on inflation and should be implemented with quantitative monetary targets.

The pure free floating and monetary rules regime performs some crisis prevention functions that are inexistent in a fixed exchange rate regime, but it does not exclude the possibility of a crisis in a situation of full financial opening. For instance, in a situation of balance of payments deficit, if an important portion of the demand for international currency is inelastic, because it is mainly originated in interest and amortisation debt commitments – private or public – as is the case of highly indebted countries, the equilibrium exchange rate could be unattainable. In this case, there will be a crisis in spite of the isolation of central bank reserves, because the debtors cannot fulfil their external obligations.

In exchange for performing some crisis prevention functions, the pure free floating exchange rate regime has an important negative attribute: the volatility of capital flows is transmitted through the volatility of nominal and real exchange rates and relative prices, with adverse effects on growth and investment. Under this regime, macroeconomic policies completely neglect real objectives, such as employment, activity level and the real exchange rate, as an intermediate target of real and balance of payments objectives.

The parallel histories of financial globalisation – allowed and induced by the liberalisation reforms – and orthodox macroeconomic regimes led to a paradoxical situation. On the one hand, the integration into the international financial markets has become an important source of volatility. On the other hand, the macroeconomic policy regimes became mainly focused on inflation control and on the prevention of balance of payments crises, in a defensive attitude towards external volatility but giving priority to the preservation of free capital mobility while other objectives were lost in the way.

It is time to revitalise the competitive and stable exchange rate as an intermediate target of macroeconomic policies that focus on growth, employment and stability. This does not mean that we should turn back to crawling pegs. The short-run flexibility of the exchange rate performs some preventive roles that should not be lost. But central bank interventions in the exchange market should be oriented to signalling the long-run stability of a competitive real exchange rate in order to give proper incentives to tradable industries, reduce the uncertainty of investment and employment decisions, and prevent unsustainable balance of payments and debt trends.

Nobody criticises the competitive and stable exchange rate intermediate target on behalf of its objectives. On the contrary, it is not easy to find arguments against the role it can play in development and employment creation. Besides, it is difficult to find any critical argument against the importance of relative prices stability. Sometimes it is argued that the real exchange rate should be determined by "the markets" since the public sector has no informational advantage over the private sector. But this theoretical argument is not very appealing because, in practice, the volatility of capital flows is evident and the floating exchange markets show intrinsic instability – also in the developed countries.

The orthodox arguments against macroeconomic policy regimes with a competitive real exchange rate as an intermediate target are more complex. They point, on the one hand, to the incompatibility of the regime with free capital flows or, on the other hand, to the impossibility of controlling inflation under this regime. In the orthodox view, it is not possible to sustain an exchange rate level – or to limit its fluctuations to a relatively narrow band – in a context of free capital mobility, while the central bank simultaneously implements a monetary policy focused on inflation – on inflation exclusively, we add.

The orthodox criticism points to actual difficulties for the implementation of a competitive real exchange rate regime in the context of financial globalisation. But that judgment is derived from confronting the regime with extreme situations of capital outflows or inflows. In addition, the orthodox perspective brings in, implicitly or explicitly, the disbelief about the ability of the government to commit itself to monetary discipline.

However, in the competitive real exchange rate regime, monetary policy cannot – and should not – focus exclusively on inflation. The monetary policy has to be broader and should simultaneously pursue exchange rate, inflation and economic activity level objectives. These objectives can sometimes be in conflict, as is emphasised by the orthodox criticism. But this is not a particular characteristic of the regime. Monetary policy in the US also pursues conflicting objectives.

In the suggested regime, the central bank should have an ample mandate. Monetary programming should be jointly formulated with the rest of the macroeconomic programming, and implementation should be frequently coordinated. In any case, the central bank independence should help to enhance the credibility of exchange and monetary policies.

It is true that free capital mobility complicates the management of monetary policy when the central bank intervenes in the exchange market. But, as was already mentioned, the conclusion that it is impossible to manage monetary policy derives from supposing huge capital flows. In other contexts, monetary policy can be managed by implementing sterilisation policies, by managing the banking system liquidity and also by prudential regulation and supervision of banks and other financial institutions. In cases where the volume of capital flows makes it impossible to manage monetary policy, regulations on capital mobility should be implemented. In case of a balance of payments surplus, there is a menu of experienced restrictive measures, such as those implemented by Chile and Colombia in the nineties. In case of a balance of payments deficit, if there are no reasons to expect an exchange rate depreciation, the monetary and fiscal policies are consistent with the exchange rate target and inflation is controlled, the policy regime and the exchange rate target should be preserved. Under these circumstances, exchange controls and restrictions on capital outflows should be imposed, as did Argentina in mid-2002. If there are no fundamental reasons for the excess demand for international currency, the controls can be temporary.

Macroeconomic Policies with Growth and Employment Objectives

To end, let me highlight three circumstances that currently facilitate the adoption of competitive exchange rate macroeconomic regimes.

First, fixed exchange rate regimes and overvalued currencies are generally left behind. Consequently, in many cases the adoption of the regime does not require an initial discrete exchange rate adjustment.

Second, the regime would generally be adopted in a low inflation context. This makes it possible to give inflation control the same priority that is given to the other objectives of macroeconomic policy.

Third, we are not living in a period of a capital inflows boom and there are no prospects of such a boom in the foreseeable future. In a rather paradoxically way, this circumstance facilitates getting macroeconomic policies on their feet and conducting them with growth and employment objectives.