

Escaping the “Policy Credibility” Trap: Reshaping the Debate Over the International Financial Architecture

Abstract

The last decade has seen policy makers in Latin America engaged in a search for “policy credibility” with international financial markets. This has led to policies of fixed exchange rates and capital openness, and it is now promoting a case for dollarization. To its credit, the policy has helped tame inflation and restore fiscal order. But that said, the policy has also been very costly in terms of unemployment, income distribution, and employment security. It has also eliminated space for national policy autonomy, resulted in an over-zealous pursuit of fiscal balance, and promoted conditions of financial vulnerability. As currently conceived, the pursuit of policy credibility has proven to be a trap. Escaping this trap requires the introduction of new international and domestic financial market regulations that preserve the dynamism of markets but create the space for national policy autonomy.

Keywords: Policy credibility, fixed exchange rates, flexible exchange rates, dollarization, capital mobility, capital controls.

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I Development and the policy credibility trap

Over the last decade Latin American policy makers have engaged in a relentless quest for “policy credibility” with international financial markets. The goal has been to win favor with financial markets, thereby encouraging inflows of foreign capital on reasonable terms that could finance sustained development. In addition, the quest has aimed at encouraging domestic wealth owners to eschew capital flight.

To its credit, this policy that has helped tame inflation and restore fiscal order.¹ But that said, it has also been very costly in terms of unemployment, income distribution, and employment security. Moreover, it has greatly reduced the space for national policy autonomy by creating conditions in which policy is hostage to the approval of financial markets. For these reasons, the pursuit of policy credibility has turned out to be a trap in which markets have become the *de facto* makers of policy. What started as a policy intended to facilitate the making of policy has turned into one that has resulted in the surrender of control over policy.

Escaping the policy credibility trap requires a new conceptualization of the policy problem. Rather than seeking to obtain credibility within the existing structure, policy makers should aim to re-engineer the structure so that it is easier to obtain credibility and financial markets have less power to veto. The challenge is how to do this in a way that retains the economic dynamism of markets. This suggests new forms of financial market regulation, including capital controls, that create the space for national policy autonomy.

¹. The restoration of fiscal order has been helped by large scale privatization of nationalized industries. This has given government significant revenues which have helped lower inflation by paying for imports and reducing claims on domestic resources. Thus, in part, both lower inflation and improved fiscal order have been achieved by “sale of the family silver.” Whether, low inflation and fiscal order can be maintained when all the silver is gone remains an open question.

Though it is possible to escape the trap by such means, it should also be recognized that doing so brings new challenges. In particular, the creation of space for autonomous policy can be used for both good and bad effect, and which outcome obtains depends significantly on the state of national politics. A healthy national politics is therefore also necessary if developing economies are to pursue successfully socially responsive macroeconomic policy. It is for this reason that human, labor, and democratic rights are integral to good economic policy - as well as having standing in their own right. The application of general equilibrium theory to the realm of policy making tells us that there can be large synergies between policies, and that poorly designed policy in one area can frustrate policy in other areas. The fact that human and labor rights policy facilitate the making of good socially responsive macroeconomic policy is another instance of this principle, albeit involving domains not traditionally viewed as economic.

II The theoretical origins of the policy credibility trap

The origins of the policy credibility trap are to be found in developments associated with the rational expectations - new classical macroeconomics school of thought that now dominates economic thinking. In his seminal critique of econometric policy evaluation, Lucas (1976) argued that economic agents make rational choices based on their understandings of the economic world, and these understandings include an understanding of government policy. Thus, if government policy changes, agents will change their behavior in response. Kydland and Prescott (1977) extended this construction of the policy problematic to an inter-temporal context, giving rise to the policy credibility problem. In an inter-temporal setting agents' decisions are based partly on expectations of future government policy, and they therefore look to the future and ask what government will have an incentive to do when that future materializes. A future

policy is time consistent (and credible) if government has an incentive to implement it at a future date, and agents will only take it into account in their decisions today if it is credible.

This formulation of the policy problematic represents a significant contribution, but it is also supportive of widely different approaches to policy. Whether a policy is time consistent and credible depends on the economic structure. This means that not only should policy makers be concerned with setting policy in a given structure, but they should also consider how structure can be changed so as to make policies time consistent. It is this latter implication which has been largely ignored in the recent debate surrounding the international financial architecture.²

II An application to the debate over exchange rate regimes and capital mobility

A recurrent problem within developing economies, and especially Latin America, has been boom and bust cycles driven by capital flows. However, in tackling this problem, unrestricted capital mobility is now treated as a given and the policy choice is presented as being one of just fixed versus flexible exchange rates.³ Yet the reality is that policy makers inevitably face a choice in which they must simultaneously choose an exchange rate regime (fixed versus flexible) and a regime governing capital mobility (restricted versus unrestricted), and the benefits of alternative exchange rate regimes cannot be fully assessed without reference to the accompanying regime of capital mobility. Moreover, in a regime of unrestricted capital mobility both flexible and fixed exchange rate systems have serious economic weaknesses. This means that as long as the question of capital account governance is off the agenda, the policy debate

². A more cynical variant might be that policy makers, acting at the behest of market participants, have created a new structure that intentionally constrains policy.

³. See for instance Frankel (1999) and Eichengreen and Hausmann (1999), both of whom sweep the issue of capital mobility under the carpet.

will flip ineffectively between the merits of fixed and flexible exchange rates.⁴

Fixed exchange rates are vulnerable to both inflows and outflows of financial capital. Inflows, which often occur in times of economic boom, put upward pressure on the exchange rate. The monetary authority is then forced to intervene to prevent appreciation, but this expands the money supply and exacerbates the boom. Moreover, this feature has worsened as globalization of financial markets has increased the size of the investor herd and made for stronger extrapolative price movements that entice larger cross-border money flows.

Contractionary fiscal policy can offset this effect, but there are significant difficulties to doing so - and these can be especially pronounced in developing economies. Thus, increasing tax rates may be administratively or politically infeasible, while cuts in government spending tend to fall hardest on the poor who are thereby made to bear the bulk of the cost despite the source of the problem being financial markets.

Just as financial inflows are problematic under fixed exchange rates, so too are outflows. Thus, governments may be forced to raise interest rates to prevent outflows and protect the exchange rate, but this increases debt burdens and slows growth. In the event that an exchange rate collapse still happens, both government and private sector agents can be left with increased interest service burdens on that part of their debt denominated in foreign currency. In this connection, fixed exchange rates may also encourage private sector agents to borrow in foreign currency terms by fostering a belief that they bear no foreign currency risk, and this means that the private sector is even more exposed to adverse debt effects should the exchange rate setting

⁴. Moreover, increased capital mobility arising from globalized financial markets may also be generating pressures that compel policy makers to choose between extremes - that is between pure flexible exchange rates or pure fixed exchange rates (i.e currency boards or dollarization).

be abandoned. Lastly, even after an exchange rate collapse the monetary authority is usually still compelled to keep interest rates high to prevent triggering an import price-led inflationary spiral.

All of the above problems have been visible in recent events in east Asia and Brazil. This has prompted a swing of the policy pendulum toward flexible exchange rate regimes, but here too capital mobility presents real problems. First, speculatively driven inflows of capital cause exchange rates to rise, which negatively impacts the traded goods sector despite the fact that nothing has changed at the factory floor level. Second, fluctuating exchange rates contribute to increased uncertainty which is disruptive to economic efficiency, and firms' attempts to deal with this uncertainty can cause additional problems. Thus, it can be argued that the spread of flexible globalized production, which has so disrupted patterns of work and employment relations, represents a corporate response to the problem of exchange rate uncertainty. Faced by rising uncertainty, corporations have responded by establishing portfolios of production facilities that span the globe, and they now shift production in response to exchange rate movements. Third, flexible exchange rate systems may be subject to significant over-shootings. Thus, exchange rate appreciation may give rise to anticipations of further appreciation that encourages further inflows and additional foreign currency denominated borrowing. This causes additional job losses and sets the stage for a larger financial market correction once the over-shoot corrects.

Just as exchange rate appreciation can cause problems, so can rapid depreciation. First, higher import prices can trigger domestic wage - price inflation if workers seek to maintain their standard of living, if firms try to pass on higher imported input costs, or if firms raise margins in face of diminished import competition. Second, exchange rate depreciation can also trigger financial crises when countries have large foreign currency denominated debts.

It is important to recognize that these problems afflict both developed and developing countries. Developed country exposure to the problems of fixed exchange rates is evident in the collapse of the European exchange rate mechanism in the early 1990s, while the manufacturing sectors of both the U.S. and the U.K. have been hurt by exchange rate appreciation in the late 1990s - just as they were in the first half of the 1980s. But these problems are compounded for developing countries. First, they borrow in foreign currency denominated terms, and this exposes them to additional financial fragility and uncovered exchange rate risk. Second, they are subject to significant capital flight on the part of domestic wealth owning elites.⁵ The problem of capital flight (especially in Latin America) has been worsened by opening of international financial markets, and it has likely had a significant negative macroeconomic effect. This effect is illustrated in figure 1 in which there is a downward sloping aggregate demand (AD) function that is a negative function of the real interest rate. The initial equilibrium is characterized by an interest rate - output pair given by $[i_0, y_0]$. Removal of controls on domestic capital outflows has caused the domestic cost of capital to rise as wealth holders have shifted wealth abroad to take advantage of new outside options. At the same time the AD function has shifted left as domestic wealth owners have used their foreign exchange earnings to accumulate foreign financial assets, rather than repatriating them and using them to finance a domestic investment boom.⁶

In the presence of unregulated capital mobility, both fixed and flexible exchange rates are

⁵. Such flight is widely believed to have been a factor in the 1994 Mexican financial crisis, and Goldfan and Baig (2000) report that it was also a factor in the Brazilian financial crisis of 1999.

⁶. This Keynesian description of the process of financial liberalization in Latin America contrasts with the neo-liberal description. Investment depends on profitability, and the cost of funds depends on monetary policy and options available to financial investors elsewhere. Far from raising investment by increasing the supply of financial funds, financial liberalization can lower investment by creating options outside the country that divert the allocation of resources.

susceptible to welfare reducing booms and busts. If international financial markets are to serve socially responsive macroeconomic policy, capital flows need to be stabilized. One measure is Chilean style speed bumps that penalize short term inflows. Not only can these measures induce a substitution toward provision of long term finance, but they can also act as a screening mechanism that screens out volatile investors (Palley, 1999a). This is because volatile investors with a high likelihood of exit find them disproportionately costly. Such controls can even increase overall inflows to the extent that they protect long term investors from costs imposed by volatile investors. A second measure is Tobin transaction taxes which add to the cost of following the herd and speculating against currencies. Moreover, both of these measures can raise revenue, and therefore have beneficial public finance implications.⁷ Third, governments should also have the right as part of the “rules of the game” to temporarily suspend capital outflows. Such controls have a place in times of financial panic, and their effectiveness has been demonstrated by Malaysia’s use of them in the crisis of 1998.⁸ Finally, with regard to the issue of domestic resident capital flows, there is a case for maintaining capital controls that directly restrict amounts of capital that residents can take out in any period.

III Credibility: Latin America’s “cross of gold”

Rather than focusing on the structure of the exchange rate - capital account nexus, the

⁷. Palley (1999b) provides a model analyzing the economic benefit of Tobin taxes. By discouraging inappropriate cashing out of investments that impose external costs on others, Tobin taxes can increase economic efficiency. However, they also discourage appropriate cashing out, and this is a source of inefficiency.

⁸. Palley (1999c) provides a model justifying temporary imposition of capital controls to stop panics that are the result of investors having inaccurate information about the underlying worth of the assets held by financial intermediaries. If national financial regulators have superior information, there is a case for temporary imposition of controls.

economics profession has preferred to construct the issue of financial instability in terms of an exchange rate - policy credibility nexus. In doing so, it has encouraged policy makers to single mindedly pursue policy credibility with financial markets. This pursuit has become Latin America's "cross of gold", with policy makers now following policies that curry favor with financial markets at the expense of full employment, growth, and other development goals.⁹

At one level, the concern with policy credibility is real. The basic message is that where agents are engaged in long lived activities (such as investment), they base their decisions on what they rationally believe policy will be in the future rather than on what governments say it will be. Moreover, in constructing these beliefs they take account of government's future self-interest and its past practices as indicators of future practice. However, that said, this does not mean that governments have to capitulate to the wants of markets. Instead, they can establish market arrangements that limit markets' ability to restrict policy.

Proponents of policy credibility maintain that if governments want to attract capital at reasonable interest rates then they must placate financial markets by convincing them that they are committed to policies of low inflation. In many instances this has led to the adoption of fixed exchange rates, and it has also encouraged governments to remove capital controls. The fixing of exchange rates is supposed to serve as a commitment device (a nominal anchor) that prevents governments from pursuing inflationary policies, and thereby sends a signal to financial markets about the credibility of a policy of low inflation. The workings of this commitment device are as

⁹. In the U.S. election of 1896, William Jennings Bryant referred to the gold standard as a "cross of gold" which was crucifying the American economy through the creation of deflationary conditions. In its place, he advocated the adoption of a silver standard which would have promoted monetary expansion. The pursuit of policy credibility has had similar effects in its promotion of monetary austerity.

follows. The exchange rate is visible to agents, and if governments start to pursue inflationary policies, this puts incipient downward pressure on the exchange rate. To maintain the fixed exchange rate, policy makers must then reverse their policies. With regard to removal of capital controls, this makes capital outflows more responsive to higher inflation, and in doing so allows market forces to exert a stronger disciplining influence on countries' macroeconomic policies.

In Argentina the push for credibility has been taken one step further through the adoption of a currency board. In addition to having a fixed exchange rate and full capital mobility, Argentina has relinquished control over its money supply and locked itself into an arrangement whereby the creation of domestic currency is tied to holdings of dollar reserves. This mechanism ties the hands of the monetary authority, and is intended to purchase further credibility by openly restricting government's ability to engage in inflationary monetary expansions.

Unfortunately, the price of credibility is proving enormously high for Latin American economies, making it almost impossible to pursue socially responsive macroeconomic policies. Monetary authorities have been compelled to pay permanently high real interest rates to attract capital and maintain exchange rates, and governments have also been compelled to engage in fiscal austerity to placate financial investors. This has resulted in depressed domestic demand conditions, high unemployment, and worsened income distribution. Moreover, living with permanently high real interest rates is itself a source of trouble since debt service burdens compound. Not only is private investment discouraged, but so too is public investment. If public investment is financed out of current revenue, other spending is displaced: if it is financed by borrowing, debt service comes to be an excessive share of government outlays.

Finally, in addition to these negative interest rate impacts, the adoption of fixed exchange

rates has given rise to other problems. First, there has been the perennial problem of speculation, with some market participants believing that profits can be made by forcing an abandonment of the exchange rate. Countering such speculation has in turn required even higher interest rates. Second, the existence of fixed exchange rates has encouraged domestic borrowers to borrow in foreign currency denominated terms, and this has created financial fragility in that economies have taken on even larger uncovered foreign exchange risks. Third, countries that have adopted fixed exchange rates have been exposed to sudden losses of international competitiveness when trading rivals have let their exchange rates depreciate. With fixed exchange rates being the center piece of the strategy of credibility, these countries have then lost export market share. This in turn has undermined confidence in the viability of the exchange rate, requiring even higher interest rates to maintain investor confidence, thereby amplifying the recessionary impact of reduced export demand.

All of these problems have been visible in recent years. In the wake of both the 1994 Mexican financial crisis and 1997 East Asian financial crisis, Latin American economies with fixed exchange rates faced heavy speculative pressures that required higher interest rates. In 1999, Brazil found itself compelled to devalue its currency after an extended period of speculative attack. This left it with depleted foreign exchange reserves and a significantly increased foreign debt burden - in part caused by borrowing to defend the exchange rate. Moreover, in order to persuade investors to stay, the Brazilian monetary authorities were compelled to continue with high interest rates after the devaluation so as to prevent import price inflation from becoming generalized. Finally, Brazil's devaluation has rendered Argentina internationally uncompetitive, and contributed to a loss of export markets and a shifting of

production from Argentina to Brazil. The new Argentinian President, Fernando De la Rúa, describes Argentina's predicament in simple terms: "If you ask me what my chief concern is in a word, that word is "competitiveness"."¹⁰

The high cost of acquiring credibility through "fixed exchange rates with capital mobility" is now promoting "dollarization." This involves replacing the domestic currency with the U.S. dollar so that the domestic currency ceases to exist. Such a move is supposed to ensure credibility by removing any exchange rate risk and by removing the threat of inflationary money supply growth, thereby eliminating the "credibility" risk premium and lowering interest rates. However, the problem with the push for dollarization is that it is being driven by the failings of existing policy (i.e. the high cost of obtaining policy credibility) rather than its own merits. Closer inspection reveals serious policy failings with dollarization. First, dollarization means that a country must immediately give up its own money and replace it with dollar reserves. In effect, this involves tying up scarce foreign exchange reserves in the money supply, and the opportunity cost of this is the interest rate that a country pays on its international borrowing.¹¹ Second, not only must the existing currency be replaced, but doing so results in the loss of all future seigniorage revenue from the issue of additional currency.¹² Third, giving up a separate domestic currency and substituting the dollar involves giving up domestic monetary policy and

¹⁰. "Argentina: New President Tries to Keep Industry From Leaving the Country," New York Times, March 8, 2000.

¹¹. Another way of thinking about it is that it is as if the dollarized developing country is making an interest free loan to the U.S.

¹². Assuming a constant money to nominal GDP ratio, seigniorage grows at the rate of nominal GDP growth. In the case of Brazil, in 1997 total reserve money was 66.6 billion reals and government consumption was 157.1 billion reals. Assuming a 10% nominal GDP growth rate, seigniorage was 6.7 billion reals or 4% of government consumption.

substituting that of the U.S. To the extent that U.S. macroeconomic conditions are different, a dollarized country risks finding that monetary policy becomes pro-cyclical and destabilizing. Fourth, having the domestic monetary authority give up the power to create money means that it no longer has the ability to act as a lender of last resort in the event of a domestic bank run. This turns the clock back on a century of domestic financial regulatory practice, and restores the financially fragile conditions that characterized banking in the 19th century. Fifth, the adoption of the dollar as the domestic currency means that a country gives up using the exchange rate for macroeconomic adjustment purposes. This is a source of gain regarding the purchase of policy credibility, but it means that a country is vulnerable to competitive devaluation by its trading rivals. Thus, the only way a dollarized country can protect its competitiveness in response to a devaluation by trading rivals is the slow contested process of domestic price and nominal wage deflation. This is the same adjustment as under the gold standard, and the history of the gold standard in the 1930s shows this mechanism to have been a catastrophic failure.¹³ Sixth, like currency boards and fixed exchange rates, dollarization represents a policy arrangement. Though more difficult to abandon, even dollarization can be repealed. This means that foreign investors will still see risks in the system, and countries will still have to pay an interest premium. Seventh, dollarization threatens to encourage global deflation. A country that dollarizes needs to run an export surplus if it is to obtain a supply of reserves that can allow its money supply to grow with nominal GDP. This has some unpleasant implications. On one hand, a country that

¹³. Dollarization and the gold standard are close cousins. However, dollarization leaves policy makers with even less room for policy manoeuvre. Under a gold standard a country retains its own currency, but can vary its issue of currency by adjusting the fiduciary ratio (the gold to currency ratio). A dollarized country loses its own currency, and the amount of money in issue is directly determined by its dollar holdings.

fails to earn an appropriate export surplus will find its money supply falling relative to nominal GDP, thereby resulting in deflation which is disastrous in modern economies marked by extensive credit arrangements. On the other hand, if dollarized countries are successful in earning sufficient export earnings, they risk amplifying the deflationary tendencies inherent in a globally constituted regime of export-led growth (Blecker, 2000).

IV Escaping the policy credibility trap: making policy the master of markets rather than markets the master of policy

The adoption of fixed exchange rates and capital mobility have both been pushed by the quest for policy credibility. Fixed exchange rates are supposed to provide a nominal anchor, while capital mobility is the discipline device that ensures that governments stick to their promise. However, this policy has failed, and some are now promoting dollarization as the ultimate fix in the quest for policy credibility. Such advice stands to compound and entrench the costs of policy credibility.

The policy credibility debate emerged out of the new classical rational expectations - time consistency revolution in economics of the 1970s. New classical thinking embeds a political economy in which markets are represented as perfectly efficient and equilibria are Pareto optimal. Market participants are represented as a unified interest representing the “true” public interest, while government is represented as a “special” interest whose actions undermine the public interest (Barro and Gordon, 1983). In such a context, it makes sense to remove regulations on markets, and place binding restrictions on government to prevent it from capriciously reversing policy course. This is the economic logic behind nominal anchors, central bank independence, and dollarization.

However, the reality is far different. Markets are not perfectly competitive - especially labor markets. Financial markets are subject to herd behavior, speculative activity, and panics, and these activities can be enormously damaging. Theorems about macroeconomic stability evaporate in the presence of domestic inside debt and foreign currency denominated debt. Most importantly, the market does not represent a unified public interest, but is instead a collection of competing private interests. Moreover, markets operate on the principle of one dollar - one vote, and this means that financial interests and the well-off are disproportionately represented.

Such considerations point to the need for a reformulation of the policy credibility problem. Policy makers have public interest goals, but their ability to reach these goals is constrained by the structure of the economy and the responses of private agents. These responses depend on the structure and rules of the economy since they establish the options available to agents. Viewed from this vantage, the issue becomes one of how to facilitate the achievement of the desired goals of socially responsive macroeconomic policy. Instead of capitulating to the demands of markets, which all too often are insatiable, policy makers should aim to sensibly change the structure of the economy. This is where rules that slow down the flow of capital and screen out volatile flows come into play, and it is in this light that the debate over the international architecture should be reshaped.¹⁴

¹⁴. In the parlance of formal economic models, the policy maker has an objective function which she seeks to maximize subject to a set of constraints that reflect the economic structure. These constraints also embody the reactions of agents which are conditioned upon their expectations of government policy. The rational expectations - time consistency approach to macroeconomics criticized Keynesian macroeconomics for ignoring the fact that agents responses depend on their expectations of policy. This criticism is appropriate. However, the rational expectations approach takes the rest of the structure as fixed, when government can in fact use policy to change this structure.

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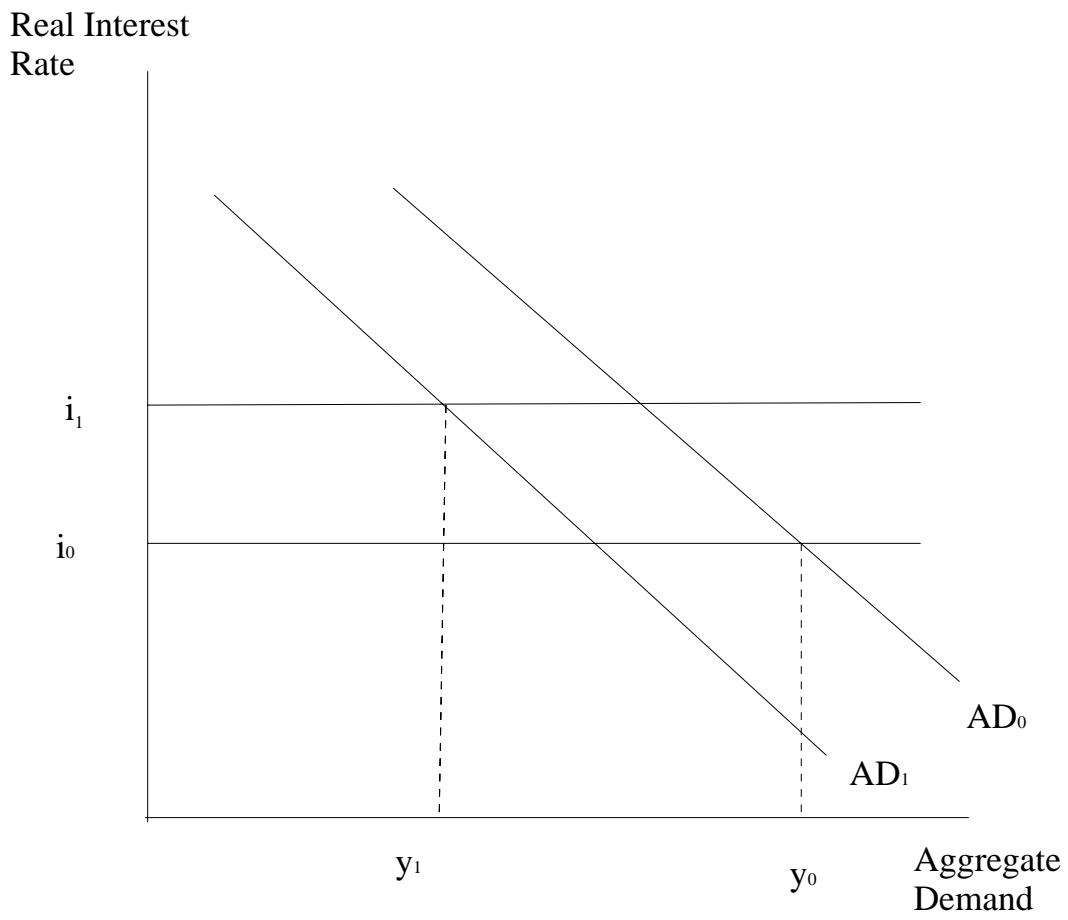


Figure 1 Capital account liberalization in the presence of domestic capital flight.