Commentary: The Integration of World Capital Markets

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The fine paper by Mr. Goldstein and Mr. Mussa encompasses a broad set of issues related to the history, measurement, and policy implications of international capital market integration. In my comments I will not focus on the empirical puzzles discussed in the paper as the other discussant, Dr. Feldstein, is much better acquainted with those questions and much better qualified to explore their resolution. Rather, I will focus on the recent episode in the European exchange rate mechanism (ERM). In particular, I will articulate my perception of what happened and why, look at some proposed reforms and efforts to repair the ERM in the context of a world economy that is adjusting to the presence of new "emerging regions," and finally, I will speculate on where the next systemic crisis could arise.

The crisis in the ERM: History

The disintegration of the exchange rate mechanism is a textbook case of re-equilibration of markets in the aftermath of a shock to the real sector. The fiscal consequences of German reunification drove a wedge between Germany and non-German Europe. The rule of thumb from textbook macroeconomicsis that real shocks require real exchange rate adjustments while financial shocks can be contained without adjusting the system.

The alternative view of the ERM crisis that is cited in some quarters explains this episode as an example of "excessive speculation," or as an "Anglo-Saxon plot" to undermine an otherwise sound and stable system. I believe such a view is without foundation.

The key challenge for the ERM was how to implement the real exchange rate adjustment given the divergence of fiscal policies between Germany and non-German Europe in the aftermath of German reunification. One way would have been to adjust nominal exchange rates. The non-German European countries were unwilling to do this because they were attempting to import credibility from the Bundesbank and to submit to arealignment would have been a setback in that endeavor.

The second means of adjustment involved maintaining fixed nominal exchange rates, within the bands, and allowing an inflation differential to emerge between Germany and non-German Europe. In that manner an adjustment in the real exchange rate could be accomplished as Germany's competitiveness deteriorated through higher relative inflation. Note the emphasis on relative inflation. That led to the key question: What would be the absolute level of German inflation that the Bundesbank would tolerate? If German inflation were held down, the credibility of the Bundesbank would be maintained but the implication was that the level of inflation or perhaps deflation that would be required in non-German Europe to facilitate the change in real exchange rates would be very difficult to achieve. When the Bundesbank would not tolerate inflation rising much above 4 percent, the downward pressure on prices and activity in most other countries in the ERM with high unemployment became too much to bear for their political economic equilibrium. This is where the markets got wind of the weakness of the ERM system. Raising interest rates to defend the currency parity no longer worked in the traditional manner of stabilizing the system because interest rates that were too high to stabilize the real economy were viewed as unsustainable by market participants. Reserves were drained by the private investors and the boundaries broke down.

Reform of the ERM

The question of reform of the ERM is now potentially quite important. In this stagnant environment the temptation for governments to engage in devaluation to export deflationary pressures is quite strong and a system that discourages that may be quite helpful in stabilizing commerce in Europe.

The remedies to exchange rate system malfunction that are proposed tend to be of two varieties. They can be classified as efforts to inhibit private sector errors or as efforts to reduce policymaker errors. Floating exchange rates with capital mobility, as we have seen, tend to punish policymakers' errors. What some call a problem may actually be a remedy.

In the first category, efforts to inhibit private sector errors from being introduced into the price system, is the "sand in the gears" proposal first espoused by James Tobin. Various forms of transactions taxes or margin requirements are proposed for inhibiting "speculative excess." One cannot deny that there is a possibility of speculative excess. The bootstrap bubble in the U.S. dollar in early 1985 was, in my view, an instance where the financial market got off on a tear, created an exchange rate misalignment, and produced an adverse impact on the real economy.

But is that the malady the ERM suffered from in this instance? I believe that this episode was the result of an error made by policymakers in the ERM. That error was reluctance on the part of governments to adjust exchange rate parities pro-actively when adjustment was warranted. Something was lost in the process of avoiding adjustments, until such time that the imbalances became so profound that the international capital markets forced them. What was lost was the credibility of European policy officials. It will now take some time for those officials to rebuild their credibility, though some seem tempted by capital controls and other mechanisms as an alternative and short cut to regaining their influence over markets.

In the current climate, many public officials are actively engaged in the ritual of scapegoating and painting a portrait of how they are trying to protect their innocent populations from speculators. I find this unfortunate. I fear that the new design of the European financial system will be compromised and poisoned by this ritual of scapegoating and efforts to regain "control" by policy officials. I would argue that the degree of policymaker control should be heartily debated as part of the process of system reform. The redesign of the European exchangerate mechanism should be done soberly according to criteria that seek to promote economic welfare of European citizens and policymaker desire to avoid further embarrassment or the psychic rents appropriated by those managing the system should be given little weight in the process. If the problem is one of policymaker reluctance to adjust, putting sand in the gears or introducing capital controls would only serve to prolong the disequilibrium and lead to an even more violent and brutal re-equilibration ultimately.

Both private market participants and policy officials are human and therefore capable of introducing error into the price mechanism. No one has a monopoly on wisdom in either the private or public sector and doing things to restore' "control" to policymakers may not be in the best interest of the citizens of Europe. Despite the difficulties of implementation, sand in the gears may be a remedy for markets plagued by flawed investors. But it certainly does not address the problem created by policymakers maintaining flawed policies in the face of a real shock when exchange rate adjustments are needed.

What are the criteria for good reforms? How does one construct a fixed but adjustable system? If one wants pure fixity, I agree with Andrew Crockett's view that one should go directly to monetary union. If that is unfeasible then one must look at the process of adjusting from one stable regime to another. I strongly applaud Jacob Frenkel for his comment at this conference when he says that a system's performance should be measured by its response to episodes of stress. At present, the credibility of the system is shattered. But the exchange rates do not appear to be far out of line with equilibrium value in the aftermath of German reunification. Adjustment to that shock appears nearly complete. The problem with refixing exchange rates is that no one can guarantee that there will not be another real sector shock that disturbs relative value in Europe. German reunification may have been more than two standard deviations from the mean shock. But one does not now put the system back together on the basis that there will be no more stress. One question that should inform efforts and design and rehabilitation of the ERM is how will a system handle the next shock of significant proportion? I think the key question for the survivability of systems promoting exchange rate stability is: How does one get policymakers to preemptively adjust exchange rates when real exchange rate adjustment is necessary? Fixity in normal times and flexibility with preemptive adjustment when stress from real shocks is strong is the prescription. The difficulty is in the details.

I believe that one important element in the details is to keep the bands wider, say 6 percent plus or minus from the central rate. Then policymakers can make adjustments by overlapping the bands on devaluations. If one moves down 6 percent then the old bottom of the band becomes the new central rate. Speculators must beware because in the lower half of the band prior to devaluation there is scope for experiencing losses if the currency appreciates after a 6 percent band adjustment. Wider bands also serve to penalize speculators if the devaluation is not implemented for there is a longer room to run if the market turns around.

Both factors tend to make the speculator more wary and tend to stabilize the currency and dampen reserve losses provided that policymakers did not delay until a very large devaluation of 15 or so percent were required to re-equilibrate the market.

There is another detail of system design that deserves attention as well. It is the problem of the distribution of the burden of adjustment between countries. I think it is quite important in this context of slack activity in Europe. As Keynes pointed out at the time of the formation of Bretton Woods, a system does not function well when the weaker currency country is called upon to do all of the adjustment.

On the other hand, in this instance, had Germany been forced to ease monetary policy in the face of the fiscal burden of unification it would have diminished the incentive for other nations to agree to an exchange rate realignment.

Some, particularly in Europe, may feel that having a system that forced Germany to ease monetary policy would have been preferred to the current debacle. That may be. Yet if Germany had been forced to ease aggressively and tolerate a significantly higher rate of inflation they would have lost that precious credibility that so many European governments have been craving to hitch their wagon to in the last few years. A system without anchor is a flotilla. I would argue that preemptive exchange rate adjustment was first best, Germany's being induced to reflate was second best, and the current system in tatters is third best. The challenge I would pose for policymakers putting the system together again is to examine the interaction between the incentive to adjust exchange rates and the mechanism for burden sharing in defense of the system.

The global challenge to Europe

The design parameters of the system and allowance for flexibility and adjustment are quite important to my mind because, while there may not be an intra-European shock of the proportion of German reunification, the world economy is struggling to adjust to the integration of the emerging countries of Asia, Europe, and Latin America. I sense that this is a horribly difficult period for politicians in the mature capitalist democracies. Rising education levels in the developing nations, computer-aided manufacturing technologies that replace skilled labor, and telecommunications that permit multi-plant global production combine to create a supply shock to manufacturing located in the Organization for Economic Cooperation and Development (OECD) nations.

In the medium to long run, the allocative efficiency of reorienting production to these lower cost areas will combine with the rising living standards, consumer spending, and infrastructure building in these emerging regions such as China, the ASEAN nations, India, Argentina, Brazil, Mexico, and some parts of Eastern Europe. This will ultimately provide a stimulus to jobs and improve living standards in the OECD nations as they export to these vibrant new regions. But in the interim, the stress on the profitability of businesses that are uncompetitive, the loss of jobs, the decline in real wages in many traditional sectors, the declining government revenue, and therefore the reduced capacity for public sector investment, and the dampened incentive for private investment at home combine to make the policymaker's challenge formidable in the traditional industrial nations. The burden on elected representatives has to be extraordinary as the demand from the body politic for some alleviation of the pain of transition makes itself felt.

Monetary policies are too tight in Europe presently. Yet businessmen complain that wages are too high and that labor is unrealistic. The problem is not one of inflation but that the level of competitiveness is way out of line with the emerging market nations. What is needed is not deflation of nominal wages with a constant exchange rate, but a gain in competitiveness accomplished by a nominal depreciation of European currencies against the dollar and dollar-pegged currencies of Asia and Latin America.

In this period of underemployment and slack capacity it is very difficult to imagine that a nominal exchange rate depreciation will not lead to real exchange rate depreciation.

It is well known that monetary policy has an impact on fiscal deficits through influencing the interest cost of public debt. But even leaving aside the impact of the interest on the debt, monetary and fiscal policy are not independent. As the pain of the adjustment burden intensifies, monetary policy that is too restrictive tends to induce fiscal expansion. Fiscal deficits expand as the cyclical decline reduces revenue and the cry for help inspires government spending by survival-oriented elected representatives.

When it comes time to decide whether to finance these shortfalls through higher taxes or through bond issuance, the international investors step up to the plate with oodles of liquidity making it easy for the bond finance route to prevail. At the same time, the future generations of young taxpayers who will inherit that debt burden do not yet scare the politicians while current taxpayers, aching from a slump and angry, are a frightening prospect. Ricardian equivalence is an elegant notion but it will hardly appease my grandson when he pays the bill. The path of least resistance, despite pronouncements from authorities, is for debt and deficit to GNP ratios to march ever upward. We are living in an era of price stability, central bank credibility, and fiscal laxity. These things are not independent.

A sovereign debt crisis in the OECD?

If there is one area I could cite today as a candidate for mispricing of risk, and therefore financial crisis, in the coming years it is in the area of sovereign debt in some OECD countries, particularly in some of the European countries that are small in relation to the wealth deployed in international capital markets. Mr. Goldstein and Mr. Mussa suggest that one role policymakers should play is to ensure risk is adequately priced internationally. I wonder if they can play such a role when the price that is too high is the price of government debt, the good that public officials can influence. I do not think the risks are imminent. Yet if we follow present trends of bond-financed deficits for another five to seven years, the problems of sovereign credit risk could become acute.

What can be done about this from the standpoint of central banks? Rather than the traditional case where the central bank holds out the carrot of lower interest rates, we now are in an environment where lower interest rates are a precondition for growth, which in turn is a precondition for the political courage to address the fiscal imbalances. The Federal Reserve, led by Chairman Alan Greenspan, has lowered interest rates to facilitate the return of growth in the United States and the Congress and the President have recently passed legislation to address the U.S. fiscal problems. One may not approve of the contents of that legislation; I do not want to debate that here. My point is only that the Federal Reserve helped to foster an economic climate that was conducive to fiscal deficit reduction. I can therefore comfortably conclude with applause for the home team and thanks to the Federal Reserve Bank of Kansas City for including me in its program.