# Foreword

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The exchange rate is the most strategic of the four macroeconomic prices, and yet it is the least studied and the most misunderstood. The interest rate is the key price in every macroeconomic textbook; inflation is the main concern of macroeconomic policy-makers; and the wage rate is, rather, the object of microeconomic analysis. The exchange rate, however, has always occupied an awkward position in economic theory. Keynes knew well its strategic role, and probably for that reason opted for fixed exchange rates in the Bretton Woods agreements. For some time, economists were freed from concerns about it. Yet, after these agreements collapsed in the 1970s and open macroeconomics became a necessity, discussion on the exchange rate returned. Neoclassical and Keynesian economists debated for years about which exchange rate regime would be more appropriate for the world – fixed or floating. The discussion got nowhere because the rich countries, primarily the United States, were not interested in creating and backing an international organization that would work as a central bank in an international monetary union – as Paul Davidson demonstrates forcefully in his chapter. In the present state of the world, an attempt to form an international monetary union would involve the central banks in defining the 'rules of the game' that permit fixing exchange rates and in accepting or inventing a common reserve asset. And Davidson adds that even for some of the more developed nations this contractual agreement seems at present impossible to achieve.

This book is essentially about the exchange rate in a world where exchange rates are not fixed but floating. Countries that have arrived at full financial integration are those that have adopted a fixed and definitive exchange rate among themselves through the acceptance of a single currency. The European Union, with its euro, is the only case that falls into this category. Countries that have formally dollarized their economies are those that have given up managing their exchange rates and accepted being appended monetarily to the United States; and the same goes for countries that have adopted a currency board system.

But these are extreme forms of dealing with the exchange rate problem. Europe was able to adopt a single currency after a long and difficult process of economic and political integration. It is probably the most extraordinary example of political and economic engineering in the history of humanity. On the other hand, dollarization and currency boards are solutions adopted either by small countries or by countries that acknowledge their incapacity to deal with exchange rates. Big countries that opt for that solution are like the man who decided to blind himself because he was afraid to see. One of the many reasons that countries must retain control over their exchange rates is that they act as stabilizing mechanisms when exogenous factors produce a balance of payments problem.

An alternative solution as extreme as dollarization or the adoption of a currency board is a fully free floating rate. This option is actually more radical than a fixed exchange rate, given that, whereas we have examples of fixed exchange rates, I know of no country that has adopted a fully free float. Nevertheless, at least rhetorically, this is the dominant policy advocated by the conventional wisdom that reigns in the international financial markets and at present in the policies of the ancillary international institutions (though not necessarily in the papers of its best economists). In fact, rather than a policy, the conventional wisdom regards the free float as the only real possibility, since markets, but not governments, are able to determine the exchange rate in an international financial environment characterized by high capital mobility.

In fact, all countries that officially float their exchange rates manage them to some degree. For small countries, and sometimes for big ones, as in the case of France in relation to Germany in the 1980s, the more obvious option is to tie the national currency to a stronger one. Another alternative, which was common among developing countries in the recent past, was to peg the exchange rate to inflation. It was a way of keeping it fixed in real terms, but it was an inflationary way of doing so since it involved indexation.

Since managing the exchange rate is viewed as a 'sin' by the high priests of conventional wisdom, and as aggression by the governments of the rich countries that espouse it, no country acknowledges that it is doing so. Malaysia's decision openly to control capital flows in order to manage its exchange rate was an exception.

According to the conventional wisdom, the exchange rate should not and cannot be managed. If you try to manage it, you run into a succession of policy mistakes. You will be involved in competitive devaluations that provoke inflation while entrenching low productivity. You will keep the exchange rate either artificially undervalued or artificially overvalued, with negative consequences for the country.

In fact, this may well happen. As a trade-off, however, I suggest that, if we want to understand the enormous success of the East Asian countries since the Second World War, if we want to know their economic policy secret, we may come up with many answers, but the central one is that they used, and continue to use, their exchange rate strategically as a tool for economic growth. For developing countries, the exchange rate, when combined with fiscal austerity, is essentially a tool for economic growth, first, because it assures a country of balance of payments stability, and second, and principally, because it increases savings and investment.

This is not the usual view of the matter, and certainly is not what the conventional wisdom says. Conventional economic theory would agree with the first reason in so far as a competitive exchange rate stimulates exports and curbs imports, and keeps the current account in equilibrium. Yet, starting in the early 1990s, the conventional wisdom began to propose that developing countries pursue growth with foreign savings, that is, growth cum debt. Thus, it became uncomfortable with the idea of balance of payments crises caused by excessive international indebtedness. Before the 1990s, the standard procedure adopted by the IMF when a country faced a balance of payments crisis was to impose fiscal adjustment and to demand exchange-rate devaluation. Since the 1990s, the second part of the standard procedure has been abandoned: because depreciation would cause inflation if the exchange rate was fixed or because the market would automatically take care of the problem if the exchange rate was flexible. The fact that the market had not taken care of the problem – that, on the contrary, it had caused it through an artificial overvaluation of the exchange rate – was not considered.

The second reason a competitive exchange rate is a tool of economic growth – that it promotes savings and investments – is strange not only to the conventional wisdom but to economic theory in general. Probably some economists had already written about it, but if they had done so they have not have been listened to. It is obvious, however, that a competitive or relatively devalued currency stimulates savings. The transmission mechanism is simple. A competitive exchange rate keeps wages down. If aggregate consumption varies essentially with total wages, it too will be kept down. On the other hand, a competitive exchange rate creates opportunities for investment in export industries, promoting an increase in investment and in GDP that exceeds the relatively repressed increase in consumption. Thus, with a relatively devalued currency, the savings rate and the investment rate will increase, or, if they are already high, the relative depreciation will be small, and the savings and investment rates will remain high.

We may give all kinds of explanations for the high savings rates in the East Asian countries, but certainly one of them is their governments' exchange-rate policies. They deliberately keep the exchange rates relatively high in dollar terms in order to sustain high domestic rates of savings and investments, and also in order to avoid the possibility of a balance of payment crisis. For a few years, in the early 1990s, they came under the influence of what I used to call the Second Washington Consensus (capital account opening and growth cum foreign savings), and indulged in being net recipients of capital flows. But the

1997 crisis taught them that being 'emergent markets' could be disastrous, and they immediately returned to their classic exchange rate policy. Since capital flows, deriving not only from export surpluses, quickly resumed, they did not hesitate to adopt the policy of buying dollar-denominated bonds in order to increase international reserves and avoid the valorization of their currencies. In recent years, as these countries realized current account surpluses and financed the large current account deficit of the United States, they were doing exactly the opposite of what conventional wisdom proposes: they were growing with foreign dissavings, that is, with current account surpluses.

Conventional wisdom does not accept this kind of reasoning, on several grounds. First, it believes that the exchange rate, like every price, has a market equilibrium level – and this is the level that it will have to obey. Thus, it affirms that it would be either impossible or unsound for a government to strive for a relatively devalued exchange rate. As a matter of fact, however, what the conventional wisdom proposes is that developing countries' exchange rates be relatively overvalued, to the extent that it proposes that they grow with foreign savings. Since foreign savings are the opposite side of the coin of current account deficits, a country that has a current account deficit is a country whose market equilibrium exchange rate is lower than it would be if the current account was balanced. Additionally, conventional wisdom supports the use of the exchange rate as an anchor for price stabilization. Such a perverse role for the exchange rate likewise involves its relative evaluation.

Conventional wisdom prefers a relatively overvalued to a relatively devalued currency in developing countries because there is no bigger threat to the rich countries than a competitive exchange rate. They fear competition from the intermediate developing countries, which pushes down their wages and threatens their current account surpluses.

Yet, as we can see clearly in this book, particularly from the chapter by Rogério Studart, international financial markets, characterized by large and unstable capital flows, became extremely dangerous for developing countries. Studart argues that this instability was triggered by the abrupt and careless integration of financial markets, which caused the macro and financial imbalances of the 1990s, particularly in Latin America – a region that accepted the strategy of growth with foreign savings. Excessive capital flows create pressure to revalue the domestic currency. On the other hand, Studart sees consumption, not investment, increasing in Latin America with the opening of capital accounts and the surge of foreign capital. However, he gives a different explanation for it. Although foreign savings should, in principle, finance investments – and, in the case of direct investments, they directly do that – in the end what has been financed in Latin America is consumption. While macroeconomic uncertainties have restrained investors, consumer credit is highly rationed in the region, and responds rapidly to changes in the supply of credit. This financial explanation for the increase in consumption is interesting, and may be viewed as complementary to the real one related to the exchange rate.

What options are left for the developing countries, given the huge flows of capital that characterize the global system today? Barry Eichengreen discusses this question in his chapter. First, he remarks that the 1997 Asian crisis and its fallout in Latin America and Eastern Europe convinced many observers that soft currency pegs are crisis-prone and that emerging markets should embrace greater exchange rate flexibility. In other words, he is saying that conventional wisdom, which supported fixed exchange rates (through currency boards or dollarization), switched to favouring greater exchange rate flexibility.

Yet he is not satisfied with these two options, and searches for a third: to accept greater flexibility for the exchange rate, and to use inflation-targeting policy as a substitute for an exchange-rate anchor. In a footnote, Eichengreen recognizes that a further option, the adjustable peg, may be viable for countries with capital controls, as the experience of China and Malaysia has shown. Yet he dismisses this option on the grounds that trends in technology and policy (domestic financial liberalization in particular) will lead additional countries to liberalize their international financial transactions, thus limiting those countries to which this option is relevant.

Eichengreen includes in his chapter an interesting discussion of inflation targeting. He distinguishes strict inflation targeting from the flexible variety. Inflation targeting is strict when only inflation enters the central bank's objective function; it is flexible when a positive weight is given to other variables, like output, and when inflation caused by variations in the exchange rate is partially disregarded, or when the inflation target is a medium-range rather than a short-range target. Yet, in so far as the target is made more flexible, the substitute anchor loses strength.

The real question is to know whether using the exchange rate as an anchor to fight inflation is sound policy, or whether the country that adopts that policy is not just replacing one evil with a worse one. An outstanding Brazilian economist, Mario Henrique Simonsen, used to say that inflation cripples, and the exchange rate kills. More traditional policies, such as keeping the budget deficit under control, and raising the interest rate when excess demand materializes, as well as more innovative ones such as eliminating all mechanisms involving indexation of wages and other prices, probably make more sense as inflation controls than using the exchange rate as an anchor. If we have learned anything from the Argentinian crisis, it is that using the exchange rate as an anchor to fight inflation is disastrous.

Just as the exchange rate is a powerful source of economic growth, it is a powerful trigger of economic crises. An overvalued currency is tempting not only because it helps to control inflation, but also because it means 'exchange rate populism' in so far as it raises wages and consumption above the potential of the economy, and implies current account deficits. If fiscal populism is the state spending more than it collects in revenues, exchange rate populism is the nation spending more than it earns. When either budget deficits or current account deficits become chronic, one can be certain that economic crisis looms.

For a developing country that is small enough not to cause competitive devaluations, the ideal policy is to keep its exchange rate stable at a relatively devalued level. I mean by a competitive or relatively devalued exchange rate the rate that balances the current account or that allows the country to build reserves. If the country is highly indebted, it will be the rate that allows it to gradually repay its liabilities. There is no doubt that globalization and capital mobility limited the capacity of countries to control their exchange rates, but this does not mean that countries cannot or should not retain reasonable command over their exchange rates.

The globalist ideology that asserts that the developing countries are in a straitjacket, and have no alternative but to open their capital account, is false. Nation-states retain a considerable degree of freedom, as the Asian countries show. The idea that Mundell's triangle of incompatibilities represents a trilemma for the developing countries is also false, since it is not difficult to choose which of the three possibilities the country should dispose of. Indeed, it is impossible to conserve autonomy in monetary policy and in exchange rate policy, and keep the capital account fully open, but there is little doubt that it is preferable for them to keep control over the interest rate and the exchange rate, even at the cost of imposing some limits on capital inflows – not outflows. The real problem that developing countries face in today's global world is not a shortage of capital but an excess. Shortage, the suspension of the rollover of existing debt, occurs only in moments of crisis; excess supply of international finance is an everyday problem. Thus, when the country becomes 'fashionable' in the realm of international finance, and capital surges towards it, some administrative measures to control it should be considered. Such control should be preceded by a policy of building international reserves, but if this policy is not sufficient to avoid an undesirable overvaluation of the domestic currency given the inflow of speculative capital, the alternative of imposing administrative controls on capital inflows should be considered. The threat from international financial markets to the effect that such policy will involve loss of credibility is empty. As experience consistently demonstrates, the international credit of a country does not depend on its subservience to conventional wisdom, on confidence-building strategies, but on the soundness of its current account and of its fiscal performance.

Does this means that growth in developing countries should essentially be based on domestic savings, and that international finance has a limited role in this respect? Essentially, it does. International finance is essential for trade, but has a limited scope when investment is to be financed. Countries face a solvency constraint that makes it unwise for them to become indebted internationally. On some occasions, when the international interest rate is low, and the profit rate expected from investments is substantially higher, it may make sense to grow with debt. Yet this process will be necessarily limited in time, since countries soon reach the threshold of foreign indebtedness – between 1 and 1.5 times exports – and are supposed to balance their current account and stop borrowing.

When I refer to the conventional wisdom of the 1990s, based on financial liberalization and the strategy of growth with foreign savings as advocated by the Second Washington Consensus, I am being precise, because John Williamson's original or 'First' Washington Consensus did not include financial liberalization among the proposed reforms. When Williamson was asked why, he responded that developing countries were not ready for it. Yet, by responding in this way, he was suggesting something popular among reformers in Washington: the problem of sequencing. In their typical strategy of defining the agenda for the developing countries, they used to say that financial liberalization should come after trade liberalization. By saying that, the agenda was already defined. For the conventional wisdom, there is no doubt that developing countries must engage in financial liberalization; the only problem is when. The 'when', however, is crucial in this case. For them, the 'when' is just after capital liberalization; for me, much later. I agree that developing countries could and probably should open their capital accounts when they cease to be net debtors internationally, and have a per capita income near to that of the developed countries.

Philip Arestis and Malcolm Sawyer say something similar in this book when they observe that monetary union should come after integration has materialized in other respects. Financial integration is a beautiful thing but probably it will not happen while countries are able to create a world political authority, as the Europeans did with the European Union. For the moment, perspectives in relation to a world government are not realistic. Thus, small countries may opt for becoming just appendages of large developed countries. Most developing countries, however, have no alternative but to protect themselves, while participating in general agreements like the UN or the WTO. To protect themselves from balance of payment crises, unemployment, and low rates of growth, the best thing they can do is to keep control of their exchange rates: not to fix them, because that is impossible, but also not to fully float them. Instead, they should keep them relatively undervalued even if this involves lower wages in the short term.