Exchange Rates and Capital Freedom in Developing Markets

Leland B. Yeager

Merits and Demerits of International Investment

Ideally, resources saved from producing for current consumption are invested where they will create the most value, whether at home or abroad. Savers and investors, dealing with one another either directly or indirectly through financial intermediaries and securities markets, both normally share the gains. Skepticism centers nowadays on hot money, herd behavior, destabilizing speculation, and banking and currency crises. Even as eminent a champion of free trade in goods and services as Jagdish Bhagwati (1998) maintains that capital is different and regrets its unrestrained mobility.

Apart from these current worries, a more general case can be made against the free movement of capital, and particularly against capital *export*. Arguably, the advantages of investment abroad *relative to* investment at home appear larger to the individual investor than they actually are for his country, creating a bias in favor of foreign lending or investment. (Murphy 1960 and Jasay 1960 report and assess such arguments.)

First, certain risks borne by a domestic investor are not risks to his country, whereas similar risks of investment abroad impose total or partial losses on the investor *and* his country. A property confiscated abroad or subjected to adverse regulation or a defaulted foreign debt is simply lost to the investor *and* his country, whereas a confiscated domestic property or an installation financed by defaulted domestic debt remains within the home country. The supposed answer that a private investor can assess risk better than bureaucrats does not face up to the divergence of viewpoints that forms the core of the argument. (Keynes [1924] 1981 elaborates on this argument in particular.)

Cato Journal, Vol. 25, No. 1 (Winter 2005). Copyright © Cato Institute. All rights reserved.

Leland B. Yeager is the Ludwig von Mises Distinguished Professor Emeritus of Economics at Auburn University.

Second, taxes on domestic property and property incomes are collected by the home government, whereas taxes collected by a foreign government on the domestic owners' property abroad may be lost, especially if the home government allows credit for foreign taxes paid.

Like these first two arguments, a third is also a kind of externalities argument. Perhaps the most subtle and questionable of all, it also hinges on divergence between individual and national viewpoints. Capital resources are complementary to other broad classes of factors (labor and land) and raise their marginal productivities. Investment abroad leaves such benefits to the foreigner, whereas domestic investment keeps them at home. (But if that aspect of capital export is worrisome, something similar may be true of labor also. There has indeed been worry about "brain drain" from some countries.)

A closely related point hinges on divergence between marginal and average returns to capital and on diminishing marginal returns (a point that could be upset by increasing returns to scale). The individual investor does not consider that his investment abroad tends to reduce returns on the foreign investments of his fellow countrymen to the benefit of foreigners, whereas investment at home depresses marginal returns to capital to the benefit of other home factors of production. This argument is loosely analogous to the terms-of-trade argument for import duties and (if constitutionally permissible) for export duties. Duties could conceivably correct for the externality of the individual importer's or exporter's not taking account of how his activity tends to raise import prices or depress export prices to the disadvantage of the home country. The analogous argument against capital export, like those concerning risk and taxes, focuses on the national interest and neglects the interest of other countries. On purely economic grounds, then, it is ironic that host countries are often reluctant and lending countries eager to expand international investment.

In some ways, of course, foreign investment can *serve* the national interest. Keynes ([1924] 1981) recognized that in the past, risking capital abroad for high returns in trading, mining, and exploitation had been of great advantage to the national fortunes of the English and Scotch. Relatedly, foreign investment might develop or cheapen sources of raw materials, improving the home country's terms of trade. And it might serve foreign-policy purposes.

Arguments over Capital Controls

The literature about volatility of capital movements has become vast. Attention centers on crises in East Asia in 1997–98, Latin

America in the 1980s and 1990s, and Russia in 1998.[1] Several of the countries involved have suffered from corruption, cronyism, insecure property rights, and political influence on industrial and banking decisions. Such chronic ills go far in explaining underdevelopment and financial fragility. Actual *crises*, however, occur not continuously but in spurts, apparently triggered by discontinuous changes in the perceived probability of disaster (Brown 1992: 295). Explaining such specific events must focus on banking, money, exchange rates, and changing expectations about them. Sometimes political events have been a factor, for example, the assassination of Mexico's leading presidential candidate in 1994 and government turmoil in Russia in 1998.

In the background of many of the crises, expectations of improving economic conditions and relaxation of controls had encouraged heavy capital inflows. (Bartolini and Drazen 1997 explain how decontrol of *outflows* may seem a good sign and so promote inflows.) Implicit or perceived government guarantees of a steady exchange rate or of the debts of banks or other large enterprises further encouraged inflows (cf. Anderson 2004: 53–58 and passim). Expectations that the International Monetary Fund would ride to the rescue of troubled countries and their creditors were also a factor.[2] Credit made easy by capital inflows promoted borrowing for purposes that proved overly optimistic. The stage was set for reversal of the flows once some event should trigger a change of prevalent opinion. Oil price increases and the recycling of petrodollars and then anti-inflationary tight money and recession in the United States and the Falklands war all figured in the Latin American debt crises of the early 1980s (Kuczynski 1992).

In East Asia, because several of the emerging economies were stabilizing their exchange rates against the U.S. dollar, its strengthening against the yen after mid-1995 contributed to real exchange-rate appreciation and reduced export competitiveness. In Thailand in 1996 a property and stock-market slump and economic slowdown

[1]See, for example, Corden (2002: chaps. 10–12); Gruben and Welch (2001); Koo and Kiser (2001); Krugman (1998); Kuczynski (1992); McKinnon and Pill (1997); Steil (2004); Schwartz (1998); Gil-Díaz (1998); Meigs (1998); Willett (1995); Brealey ([1999] 2002); and Chiodo and Owyang (2002).

[2]"Since 1971, the IMF has been looking for new things to do. It has now solved its problem by creating moral hazard, allowing international banks to avoid the risks they undertake by imprudent lending. The IMF encourages the behavior that creates the problems. It engages in subterfuge by refusing to call the Indonesian cessation of payments a moratorium. To prevent an even larger future financial crisis, we must end this system and create very different arrangements in its place" (Meltzer 1998: 272; cf. Schwartz 1998: 254–55). Brealey ([1999] 2002: 487–88), however, noting that international banking is a competitive activity, doubts that the major international banks have been the main beneficiaries of IMF bailouts, but I do not quite see what competitiveness has to do with the matter.

caused difficulties in the financial sector. High interest rates made the sector more vulnerable but seemed necessary to keep foreign investors willing to finance the large current-account deficit. The baht came under pressure at times in the second half of 1996 and early 1997. To maintain investor confidence and protect an economy with a large foreign debt, the authorities remained committed to their policy of pegging to a dollar-dominated basket (Bank for International Settlements 1997: 40–41, 45, 107–14, written before the crisis actually struck).

Pressures on the exchange rate and the banks often interacted. An exchange depreciation would increase the burden of debts denominated in foreign currency, weakening debtor enterprises and banks that had made loans to them. Currency mismatches were accompanied by maturity mismatches: banks had gone too far in borrowing short to relend long. The central bank's expansion of high-powered money to improve the liquidity of a shaky banking system would further threaten the local currency's exchange rate. The crises had a vicious-circle character as capital ran for the exits. Analysts often mention contagion and herd behavior, although (according to Neal and Weidenmier 2002, anyway, and Schwartz 1998) what looks like contagion may often result from preexisting economic interdependence or shared shocks. Agreed, mindless herding is not the main story, even though, quite plausibly, crisis in one country can raise attention to financial fragility in others.[3]

Anyway, the idea of controls to restrain capital outflows—or volatile inflows in the first place"—has now regained some of its lost respectability. Perhaps a capital-importing country could deter excessively volatile capital movements while leaving the field open to productive international investment. Equity investment, particularly direct investment, might be given preference over other investment and over loans, with the distinction somehow enforced. Controls might be imposed only temporarily in exceptional situations. But suggestions like these are, at worst, mere strings of nice-sounding words.

Sounder advice is to be careful with the sequencing of liberalization measures during a transition from tight regulation to free markets (Edwards 1999: 66–67, 82). Liberalization in process is different from liberalization already accomplished. Capital controls prematurely removed may have been serving as a second-best palliative of harm done by interventions still remaining, including implicit or explicit

[3]Like Lux (1995), I am inclined to take such behavior more seriously than is respectable among sophisticated economists; "irrational exuberance" and its opposite sometimes do affect stock and real-estate markets.

government guarantee of deposits in government banks or in only recently privatized or inadequately supervised banks, as well as a perceived "too big to fail" attitude toward some banks and other enterprises. A related difference hinges on whether financial freedom has existed long enough to become entrenched or is recent and incompletely adjusted to.[4]

Absent strong financial supervision in lending or borrowing countries, Sebastian Edwards writes, "unregulated capital flows may indeed be misallocated, eventually generating waves of major disruptions in the receiving nations." Many authors, Edwards included, "have argued that the relaxation of controls on international capital movements should take place towards the end of a market-oriented reform, and only after a sound supervisory system for the domestic financial market is in place. Controls on capital movements should be lifted carefully and gradually, but—and this is the important point—they should be lifted" (Edwards 1999: 82–83).

Controls on capital outflows imposed before a devaluation crisis and intended to slow the drainage of international reserves ("preventive" controls, as Edwards calls them) have sometimes been counterproductive. Giving policymakers and observers a false sense of security even though subject to evasion, they have sometimes intensified outflows anyway. Goldman-Sachs, for example, argued that its bad ratings of Korea's banks and central bank should be excluded from computation of the country's overall vulnerability index because it had "a relatively closed capital account." During most of 1997, therefore, that firm played down Korea's problems. If it had recognized that capital controls cannot truly protect a financially weak economy, it would have expected the Korean debacle, as it did expect the Thai meltdown. During 1997–98, similarly, controls gave Brazilian policymakers a false sense that their currency could not suffer the same fate as Mexico's had suffered in 1994–95. But as in Mexico, once the collapse of the currency became imminent, investment funds fled the country (Edwards 1999: 68–69).

As for controls of a second ("curative") type, controls imposed or intensified during a crisis and intended to give time for financial restructuring and to permit lower-than-otherwise interest rates and pro-growth policies, Edwards finds them not very helpful on average. Far from resulting in orderly reforms, they have sometimes allowed politicians to experiment with populist policies that encouraged

[4]The crises of the 1980s and 1990s apparently illustrate the pains of incorrectly sequenced and not-fully-adjusted-to financial decontrol (cf. McKinnon and Pill 1997).

corruption and finally deepened the crisis after all (Edwards 1999: 69–71).

After reviewing various studies of his own country, Chile, and other countries, Edwards concludes that while controls have not been totally ineffective, neither have they been very effective. And Chile's controls had costs, particularly in increasing the cost of capital for small- and medium-sized firms that found it difficult to evade the controls on funds from abroad. "The long-term solution . . . is for countries to pursue sound macroeconomic policies, to avoid overly rigid exchange rates, and to implement banking supervisory systems that reduce moral hazard and corruption" (Edwards 1999: 82–83).

The Tobin Tax and Similar Measures

Despite this overall judgment, we should look at some specific proposals. James Tobin (1978: 154) famously proposed a small uniform tax on foreign-exchange transactions to "throw some sand in the wheels of our excessively efficient international money markets." The tax would supposedly restore some measure of monetary autonomy to countries, make exchange rates less volatile, and yield revenue for international purposes. Many but not most commentators apparently still take that idea seriously (Dautremont-Smith, Grabel 2002, and Schmidt 2000 are relatively sympathetic to it; Terzi 2003 and Garber and Taylor 1995 are skeptical). But given the wide dispersion of foreign-exchange markets and transactions, the tax, to be effective, would have to be implemented by all countries at the same time, which seems technically and administratively infeasible (Edwards 1999: 66). Another objection notes that transactions in the spot and forward foreign-exchange markets are overwhelmingly not transactions with final commercial customers and investors but wholesale transactions among professionals undertaken to adjust their positions in the short run and keep the markets functioning actively (Terzi 2003). If a Tobin tax did restrain destabilizing speculation as intended, it would also work against these facilitating transactions and against *stabilizing* speculation.

Proponents of controls are inclined to put a favorable interpretation on Chile's experience in 1978–82 and 1991–98 with a measure intended to restrain capital inflows otherwise subject to sudden reversal (and so also to restrain "real" exchange-rate appreciation and to weaken the link between home and foreign interest rates). This so-called *encaje* required a specified fraction of the amounts of designated inflows to be deposited interest-free for a year with the central bank. The requirement thus amounted to a tax, a partial variant of the

Tobin tax. However, Sebastian Edwards interprets his country's measure skeptically. "The private sector quickly found ways of avoiding the controls. The most common mechanism was misstating the purpose of the inflow; for instance, short-term portfolio flows were often labeled as trade credits or as loans supporting a direct foreign investment project. . . . In 1998, in an effort to close additional loopholes, the controls were extended to Chilean stocks traded on the New York Stock Exchange and to international bond issues." But it would be an exaggeration to say that the policy achieved its goals. And the controls had costs, including an increased cost of capital (Edwards 1999: 71–72, 82).

Some have argued that the Mexican foreign-exchange crisis of 1994–95 could have been avoided by sharp restrictions on the previous inflow of financial capital. But conditions that could spur foreign investors to pull their money out of a country would also spur domestic residents to move funds abroad. It seems unlikely in a typical episode that foreign investors are distinctively the initiators of financial crisis. According to press reports, primarily Mexicans, not foreigners, started the run from the peso in December 1994 (Willett 1995: 5; on Mexico, cf. Corden 2002: 161–71, Gil-Díaz 1998, and Meigs 1998).

More about Evasion

No one denies that economists can imagine or identify cases in which exchange and capital controls could theoretically be justified as second-best offsets to other flaws in government policy or in the private economy—for example, as correctives to distortions left by a not-yet-completed process of liberalization. Günther Schulze recognizes that although second-best arguments cannot be refuted on logical grounds, they are empirically irrelevant. There is no such creature as a welfare-maximizing benevolent dictator. Controls have been a tool for politicians and bureaucrats pursuing their own purposes (Schulze 2000: Part I: esp. 100–102).

Not the Tobin tax in particular but capital controls in general "often breed corruption and always engender distortions. Human ingenuity usually ensures that their effectiveness is eroded over time, through avoidance and evasion. And to sustain effective capital controls indefinitely, a government has to be prepared not only to intervene heavily throughout the trade and financial system—a policy that has highly undesirable side effects—but it must also be disciplined enough (which few are) to limit excessive capital inflows during boom times." Thinking about capital controls should start with focused,

temporary measures aimed at stemming massive temporary inflows or outflows (Rogoff 2002).[5]

Some methods of evasion are familiar from experience with exchange controls, especially when exchange-rate adjustments are expected.[6] Funds can be transferred across borders through deceptive invoicing of exports and imports, rigging of transfer prices for transactions among divisions of international companies located in different countries, leads and lags in the settlement of commercial transactions, and variations in trade-credit terms. Forward-exchange transactions and changes in hedging practices provide other means of evasion. "The more integrated an economy becomes, and the greater the array of instruments, including derivatives, the easier it will be to circumvent controls" (Asian Development Bank 1998: 11). Small and medium-sized firms suffer discrimination because large firms, with their access to international finance, their diversified activities, their connections, and their ability to reconfigure their assets, are better able to evade controls (Edwards 1999: 72, 82).

Evasion enters into Joshua Aizenman's (2004: 65) point that "Like it or not, greater trade integration erodes the effectiveness of restrictions on capital mobility." (A government might not like that truth because financial repression can work as a kind of implicit tax enabling it to service its domestic debt more cheaply.) Increased openness to trade—itself desirable for widely recognized reasons—multiplies opportunities to evade capital controls, as through the misinvoicing of imports and exports. For emerging markets successfully integrating into the world economy, financial opening is a question not of if but of when and how.

In more detail than other writers cited here, Peter Garber emphasizes the role of derivatives. He explains how various kinds—forward and futures contracts, options, swaps, structured notes, and other arrangements often not appearing on balance sheets—are used to evade both restrictions on capital flows and regulations concerning the foreign-currency positions and domestic activities of banks

[5]Rogoff continues (in an IMF publication, interestingly): "Even where some limited form of capital control is warranted on economic grounds, actual implementation is all too often dominated by political considerations, and the results are not pretty. A few powerful political stakeholders benefit but only at a high cost to other citizens. And no country that has made substantial progress in capital account liberalization has been inclined to reverse that progress in any long-term sense—not even countries that have suffered crises. Countries that have opened up their capital accounts seem to believe that whatever problems they faced in liberalizing, the benefits will exceed the costs going forward."

[6]The Asian Development Bank (1998) reviews them, stressing the long-run ineffectiveness of measures to suppress evasion (cf. Schulze 2000, Part II).

(Garber 1998, 2000; Garber and Taylor 1995). Looking only at the balance sheets of institutions involved gives a false impression of currency positions and of where exchange-rate and other risks actually fall. Advice seeming to be common sense, such as that governments with shaky credit should try to borrow at long- rather than short-term, may prove empty. "If the foreign lenders [sic] view of the risks is that they warrant only short term lending, a prescription to lengthen the debt is an irrelevancy. Even if it is undertaken on-balance sheet, it will be undone off-balance sheet" (Garber 1998: 30–31). Relatedly, doubts arise about not only the accuracy but even the very meaning of balance-of-payments statistics and related official statistics, including sizes of official reserves, all of which casts suspicion on econometric studies relying on such statistics. The near-incomprehensibility—to nonspecialists—of derivatives and the evasions they facilitate testifies to the inventiveness of "financial engineering firms" (as Garber calls them).

Complexity and change handicap legislators, the courts, the press, scholars, and public opinion in resisting unfairness in controls and their administration. The issues are too technical. The courts must largely depend on experts—the controllers themselves—for matters of fact; scholars can concern themselves with basic principles but hardly with details of administration.

Controls favor companies and persons willing and able to evade them. The more generally regulations are obeyed, the more profitable violation or evasion becomes for a less scrupulous minority. By shunning questionable deals, scrupulous citizens are leaving violators or evaders with something in the nature of a rent from the scarcity of their willingness to circumvent the law. Law-abiding citizens may feel that their own obedience is benefitting less conscientious persons. Those with a vested interest in controls are likely to include the controllers themselves (a pervasive theme of Schulze 2000). A law against capital transfers contrasts with a law against murder. By refraining from murder, law-abiding persons do nothing to make murder significantly easier or more profitable for others. A further reason why controls are sometimes said to breed cynicism and disrespect for law is that their enforcement requires declaring many actions illegal that are not in themselves morally wrong, so it tends to blur the distinction between right and wrong. All this raises questions about the effect of controls on freedom.

None of these points denies that capital controls may serve their intended purposes to some extent for a while. Of course evasion can be combated. But if governments try to maintain controls for long periods, a kind of arms race looms between controllers and evaders.

If controls are to be enforced in the face of strong incentives to violate or evade them, intellectual and other resources must be diverted not only from actual production but also from fighting terrorism and other crimes that are illegal not merely because so declared but because they are grossly immoral.

Something must be wrong with economic arrangements that seem to make capital controls advisable from time to time. It is here, according to a general principle of welfare economics, that attention should focus. Applied elsewhere than at the point of distortion, a supposed corrective measure, instead of exactly offsetting the original distortion, forms a new one that may do more harm than good on balance (cf. Johnson 1965). Rather than changeable controls that undercut reliance on price and profit incentives, the ultimate aim is a stable set of institutions and policies. Unsatisfactory background conditions often include poor institutions and policies—notably including exchange-rate policy.

Exchange Rates

The literature on optimum currency areas bears on a country's choice between a firmly fixed exchange rate and an independent currency with a flexible rate.[7] In realistic cases, however, some considerations pull one way and others the other way, yielding no obviously correct choice. Political considerations, furthermore, may well trump economic analysis, as seems to have happened in the euro area. Finally, as argued toward the end of this article, the choice of an exchange-rate system is less fundamental than the nature of the money units themselves.

Pegged exchange rates just cannot be counted on to remain fixed eternally. Notoriously, they have contributed to crises of the East Asian and Latin American types. A pegged rate keeps pressures of disequilibrium pent up until it comes under one-way-option suspicion, sometimes touching off a chain reaction involving other currencies. Under complete monetary unification or under freely floating exchange rates, adjustment to balance-of-payments disturbances is more continuous and more dispersed over time and among potential focuses of speculative attention.

In contrast to standard opinion as recently as 10 or 15 years ago, conventional wisdom among economists now rejects an intermediate exchange-rate system in favor of the "corner solution" of either free

[7]For a review of this literature, see Yeager (1966, 1976), and Corden (2002).

floating or rates fixed permanently enough to amount to monetary unification (Tavlas 2003: 1216). Williamson et al. (2003) register a dissent, mentioning that Singapore fared well with an intermediate regime in 1997–98; Corden (2002) also treats intermediate systems respectfully. Tavlas (2003: 1215–16n.) cites a few other dissenters from the "hypothesis of the vanishing middle."

But the pegged but adjustable exchange rate of the Bretton Woods system is to be condemned almost unequivocally. And managed floats have a way of evolving into a de facto adjustable peg, either a peg at a set rate or a crawling peg. (The term "fear of floating" has become known in this connection.) "Soft pegs," adjustable or crawling wide bands, managed floating, and the like have indeed sometimes seemed to work for a while. But does a temporarily viable arrangement amount to a durable *institution*?

Is even a currency board enough of a corner solution? Suppose that the local currency becomes overvalued, possibly through appreciation of the anchor currency or depreciation of competitor-country currencies. So what if the local monetary base is backed 100 percent or more by foreign-exchange reserves? Ample reserves do not avoid the consequences of the exchange rate's having gotten out of line with relative purchasing powers. Reserve losses and redemptions of fractional-reserve bank-account money, even without exhausting the foreign reserves, could shrink the local money supply, tightening credit painfully in the process. (Forcing banks to hold 100 percent reserves of base money is quite impracticable, in my view.)

Argentina's so-called currency board (admittedly deviating from the real thing in important features) was established by the convertibility law of 1991 to peg the peso rigidly at par with the U.S. dollar. Yet it was hit by the supposed "tequila effect" of the Mexican crisis of 1994–95. Earlier, reforms had attracted capital inflows; but then appreciation of the dollar had dragged the peso into being overvalued (an interpretation, however, that some dispute); and inflows gave way to outflows. Argentina managed to maintain the dollar peg at that time, but at the costs of borrowing to bolster the international reserves, increased interest rates, a credit squeeze, and a sharp if brief recession in economic activity (Bank for International Settlements 1996: 42; International Monetary Fund 1996: 71–72). A subsequent test was even more painful; the system collapsed and the peso was floated early in January 2002. Even Hong Kong's currency board suffered a speculative attack in 1997–98; and although the pegged rate did hold, several years of deflation were painful (Dées and Rzepkowski 2000, Sukri 2003). The lesson seems to be that even an exchange rate fixed by a currency board is not far enough from the

opposite pole of free floating to be perfectly secure. Even the security of complete monetary unification (e.g., the euro) comes at a price.

Controls and Exchange Rates: Conclusion

Nice-sounding strings of words do not actually solve problems, real or imagined (as admirers of Woodrow Wilson and Adlai Stevenson sometimes forgot). Such strings are, for example: controls just to resist herd-like capital movements but not to impede genuine investment flows or market-making or arbitrage; official market interventions just to smooth out short-run zigzags in exchange rates but not to resist fundamental trends; interventions just to keep rates within bands compatible with fundamental equilibrium and to avoid "misalignments." A laundry list of good intentions and desired results is not a policy.

A policy that economists can argue for in the abstract, such as correcting externalities thought to be associated with capital movements, is not necessarily one that politicians and bureaucrats could enact and administer honestly and effectively, particularly in the context of democratic pressure-group politics. The live policy question for national economies and the international economy is what kind of system is best on the whole—dirigisme or free markets? The logic of leaving economic actors free to respond to price and profit incentives, constrained only by standard morality and a stable framework of law, is compelling. It seems perverse, then, to subvert the logic of prices and profits by changeable regulations incompatible with the rule of law.

Things More Fundamental Than Exchange Rates

Currency and banking crises presuppose some central focus where loss of confidence can strike, such as the exchange rate or the adequacy of bank reserves. Worries circulate that devaluation or depreciation of some currencies will trigger devaluation or depreciation of others. This interdependence is genuine, but it is an interdependence largely of big-player decisions and actions. Suppose that currencies were floating freely in the first place, with something other than the exchange rate providing a "nominal anchor" for a country's monetary system. Expectations would then be spatially and temporally diffused over a large number of relatively small changes in conditions and responses. The diffusion would be greater if money and banking systems ceased being managed by national governments, leaving attention to focus on each individual lending or borrowing or

money-issuing institution and so forestalling any *concentrated* loss of confidence.

More fundamental, however, than the narrow topic of exchange-rate systems and exchange or capital controls is the nature of the national money units that trade against one another. These units remain absurdly undefined and precarious in value—unless the "inflation targeting" practiced or announced in some countries somehow counts as a monetary standard. The dollar, our unit for expressing prices and debts and accounts, is the value of nothing more substantial than the scruffy dollar bill.

Like other economists, I have made the following point before; but I halfway hope that bond traders and markets in general will not take it seriously until I am dead, for experiencing or even observing its being borne out could be painful. Bad though the situation may be in some emerging market economies, it is sobering that the same situation afflicts developed countries in Europe and even the United States. Politicians' fiscal recklessness has resulted not only in a huge acknowledged national debt but in a many times larger excess of future commitments over future revenues on account of Social Security and Medicare. No politically tolerable fix seems available. Default looms sooner or later, whether explicit or, as seems more likely, implicit through monetary and price inflation (see, e.g., Kotlikoff 2004 and Shaviro 2004). On reflection, it must seem preposterous that the U.S. government is still able to sell bonds denominated in nothing sounder or better defined than the fiat money that it itself prints.

No doubt monetary policy can still function in the present stage of monetary evolution; but the evolution continues, with traditional means of payment and central-bank base money continuing to lose relative importance (which leads Dowd 1998 to wonder whether monetary systems of our present type can endure). Apart from all that, the financial exigencies of government, together with absence of competition to force adherence to any definition of money's value, contribute to treating upward deviations from any specified price level or price-level path or inflation rate as spilt milk. Our monetary standard is heading toward, or has already become, nothing better than an "Oops!" standard.

I do not want to describe again in any detail a reform that seems economically (though not yet politically) attractive: get governments out of the money business. (While this reform could put the monetary system on a sound basis and help impose financial discipline on governments, neither it nor any other that I can think of easily remedies past irresponsibilities and solves the problem of explicit and implicit

government debt.) No longer would each country or currency area have any single exchange-rate-pegging agency and single issuer of base money. Issuing money—of defined value—would be left to private institutions. A consensus would probably develop on the composition of a basket of goods and services in which issuers, responding to pressures of competition, would denominate their moneys. Part of the argument for free banking of this sort is the argument for separating the legal regulation of economic activities from their actual conduct—the argument for having the legal enforcers of contracts be distinct from the business people and consumers who make and abide by contracts, the argument for having bank regulators distinct from bankers. Under free banking, government would simply force money-issuers to abide by ordinary law and to live up to their contracts. Such a system admittedly presupposes a degree of financial and technological sophistication unlikely to be available from the start in emerging markets. That is one argument for permitting the free entry of foreign banks and for not discriminating against them in favor of domestic banks.

What about Countries without Emerging Markets?

Still more fundamental than the specifics of monetary and exchange-rate systems is how secure the rule of law and property rights are and how stable the political system. "Emerging markets," as I understand the term, designates countries emerging from underdevelopment or communism and making real progress toward capitalism. Some backward countries, by contrast, are basket cases. It is ridiculous to prate about bringing "democracy" to them. (That word is often used—in a way that subverts clear thinking—to lump a variety of distinct good things uncomfortably together under a single label.)

We in the West have no obligation to provide aid of kinds that are bound to prove futile or worse ("ought presupposes can"; cf. Brumm 2003 and Ovaska 2003). Mary Anastasia O'Grady (2004) quotes Peter Bauer as saying that in certain conditions, a foreign military presence to guarantee security might support economic development more effectively than financial aid. If we have an obligation to give any help at all, it must be of a kind that has a chance of succeeding. That would be a strong government of limited functions administered under an international mandate by a designated foreign country (other than the United States, I hope, or even by a corporation under contract with the mandating authority). The people of a mandated country might gain experience with stability under the rule of law and enjoy the consequent economic development, eventually becoming ready for

political democracy. But a mandate should not be imposed, only offered subject to a plebiscite following an educational campaign. If the people vote to reject the offer, so be it.

References

Aizenman, J. (2004) "Financial Opening and Development: Evidence and Policy Controversies." *American Economic Review* 94 (May): 65–70.

Anderson, R. E. (2004) *Just Get Out of the Way: How Government Can Help Business in Poor Countries*. Washington: Cato Institute.

Asian Development Bank (1998) "Exchange Controls: The Path to Economic Recovery in Asia?" *EDRC Briefing Notes*, No. 4 (October) (www.adb.org/Documents/EDRC/Briefing_Notes/BN004.pdf).

Bank for International Settlements (1996, 1997) *66th Annual Report* and *67th Annual Report*. Basle, Switzerland: BIS (June of each year).

Bartolini, L., and Drazen, A. (1997) "Capital-Account Liberalization as a Signal." *American Economic Review* 87 (March): 138–54.

Bhagwati, J. (1998) "The Capital Myth: The Difference between Trade in Widgets and Dollars." *Foreign Affairs* 77 (May-June): 7–12.

Brealey, R. (1999) "The Asian Crisis: Lessons for Crisis Management and Prevention." *International Finance* 2 (2). Reprinted in C. Goodhart and G. Illing (eds.) *Financial Crises, Contagion, and the Lender of Last Resort,* 471–89. Oxford and New York: Oxford University Press, 2002.

Brown, B. (1992) "Capital Flight." In P. Newman, M. Milgate, and J. Eatwell (eds.) *The New Palgrave Dictionary of Money & Finance,* Vol. 1: 294–96. New York: Stockton Press.

Brumm, H. J. (2003) "Aid, Policies, and Growth: Bauer Was Right." *Cato Journal* 23 (Fall): 167–74.

Calomiris, C. W. (1998) "The IMF's Imprudent Role as Lender of Last Resort." *Cato Journal* 17 (Winter): 275–94.

Chiodo, A. J., and Owyang, M. T. (2002) "A Case Study of a Currency Crisis: The Russian Default of 1998." Federal Reserve Bank of St. Louis *Review* 84 (November/December): 7–17.

Corden, W. M. (2002) *Too Sensational: On the Choice of Exchange Rate Regimes*. Cambridge, Mass.: MIT Press.

Dautremont-Smith, J. "Time for a Tobin Tax?" (www.wscsd.org/ejournal/IMG/pdf/Tobin_tax.pdf).

Dées, S., and Rzepkowski, B. (2000) "Le Currency Board de Hong Kong face aux crises spéculatives." *Lettre du CEPII*, No. 186 (January) (www.cepii.fr/francgraph/publications/lettre/resumes/2000/let186.htm).

Kevin D. (1998) "Monetary Policy in the 21st Century: An Impossible Task?" *Cato Journal* 17 (Winter): 327–31.

Edwards, S. (1999) "How Effective Are Capital Controls?" *Journal of Economic Perspectives* 13 (Fall): 65–84. A shorter and slightly different version, "The Mirage of Capital Controls," dated May 1999, appears at www.anderson.ucla.edu/faculty/sebastian.edwards/for_aff.pdf.

Garber, P. M. (1998) "Derivatives in International Capital Flow." NBER Working Paper No. 6623 (June) (www.nber.org/papers/w6623).

________ (2000) "Post-Crisis Sovereign Risk Management Practices." Video presentation (28 April) (www.visualcommunications.com/wb/emnfs/p5/p51s2home.htm).

Garber, P. M., and Taylor, M. P. (1995) "Sand in the Wheels of Foreign Exchange Markets: A Sceptical Note." *Economic Journal* 105 (January): 173–80.

Gil-Díaz, F. (1998) "The Origin of Mexico's 1994 Financial Crisis." *Cato Journal* 17 (Winter): 303–13.

Grabel, I. (2002) "Capital Account Controls and Related Measures to Avert Financial Crises." Paper presented at the Alternatives to Neoliberalism Conference sponsored by the New Rules for Global Finance Coalition (23–24 May) (www.new-rules.org/Docs/afterneolib/grabel.pdf).

Gruben, W. C., and Welch, J. H. (2001) "Banking and Currency Crisis Recovery: Brazil's Turnaround of 1999." Federal Reserve Bank of Dallas *Economic and Financial Review* (Q4): 12–23.

International Monetary Fund (1996) *Annual Report of the Executive Board for the Fiscal Year Ended April 30, 1996*. Washington: IMF.

Jasay, A. E. (1960) "The Social Choice Between Home and Overseas Investment." *Economic Journal* 70 (March): 105–13.

Johnson, H. G. (1965) "Optimal Trade Intervention in the Presence of Domestic Distortions." In R. E. Baldwin et al. (eds.) *Trade, Growth, and the Balance of Payments*, 3–34. Chicago: Rand McNally.

Keynes, J. M. (1924) "Foreign Investment and National Advantage." *Nation and Athenaeum* 35 (9 August): 584–87. Reprinted in his *Collected Writings*, Vol. 19, Part 1: 275–84. Ed. by D. Moggridge. Cambridge: Macmillan and Cambridge University Press for the Royal Economic Society, 1981.

Koo, J., and Kiser, S. L. (2001) "Recovery from a Financial Crisis: The Case of South Korea." Federal Reserve Bank of Dallas *Economic and Financial Review* (Q4): 24–36.

Kotlikoff, L. (2004) "Après Bush . . . le Déluge?" *Milken Institute Review* 6 (Q2): 16–25.

Krugman, P. (1998) "What Happened to Asia?" (January) (http://web.mit.edu/krugman/www/DISINTER.html).

Kuczynski, P.-P. (1992) "Debt Crisis." In P. Newman, M. Milgate, and J. Eatwell (eds.) *The New Palgrave Dictionary of Money & Finance,* Vol. 1: 582–84. New York: Stockton Press.

Lux, T. (1995) "Herd Behaviour, Bubbles and Crashes." *Economic Journal* 105 (July): 881–96.

McKinnon, R. I., and Pill, H. (1997) "Credible Economic Liberalizations and Overborrowing." *American Economic Review* 87 (May): 189–93.

Meigs, A. J. (1998) "Lessons for Asia from Mexico." *Cato Journal* 17 (Winter): 315–22.

Meltzer, A. H. (1998) "Asian Problems and the IMF." *Cato Journal* 17 (Winter): 267–74.

Murphy, J. C. (1960) "International Investment and the National Interest." *Southern Economic Journal* 27 (July): 11–17.

Neal, L., and Weidenmier, M. (2002) "Crises in The Global Economy from Tulips to Today: Contagion and Consequences." NBER Working Paper

No. 9147 (September) (www.nber.org/books/global/neal-weidenmier8-12-02.pdf).
Neely, C. J. (1999) "An Introduction to Capital Controls." Federal Reserve Bank of St. Louis *Review* (November/December): 13–30.
O'Grady, M. A. (2004) "Aristide's Ghost Still Haunts Haiti." *Wall Street Journal* (14 May): A13.
Ovaska, T. (2003) "The Failure of Development Aid." *Cato Journal* 23 (Fall): 175–88.
Reinhart, C. M. (2000) "The Mirage of Floating Exchange Rates." Followed by discussions; reprinted from *American Economic Review* 90 (2): 65–70 (www.bankofcanada.ca/publications/working.papers/2000/reinhart.pdf).
Rogoff, K. S. (2002) "Straight Talk—Rethinking Capital Controls: When Should We Keep an Open Mind?" *Finance & Development* 39 (December) (www.imf.org/external/pubs/ft/fandd/2002/12/rogoff.htm).
Schmidt, R. (2000) "Efficient Capital Controls." International Development Research Centre, Government of Canada (December) (200http://www.unu.edu/p&g/gesgp/workingpapers/Schmidt.pdf).
Schulze, G. G. (2000) *The Political Economy of Capital Controls*. Cambridge: Cambridge University Press.
Schwartz, A. J. (1998) "International Financial Crises: Myths and Realities." *Cato Journal* 17 (Winter): 251–56.
Shaviro, D. N. (2004) "The New Age of Big Government." *Regulation* 27 (Spring): 36–42.
Steil, B. (2004) "The Curse of Currency Autarky." *Wall Street Journal* (22 April): A18.
Sukri, A. (2003) "Hong Kong's peg turns 20, debate grows over future." Reuters dispatch (16 October) (www.forbes.com/business/newswire/2003/10/16/rtr1110735.html).
Tavlas, G. S. (2003) "The Economics of Exchange-Rate Regimes: A Review Essay." *The World Economy* 26 (August): 1215–46.
Terzi, A. (2003) "Is a Transactions Tax an Effective Means to Stabilize the Foreign Exchange Market?" Banca Nazionale del Lavoro *Quarterly Review* 56 (December): 367–85.
Tobin, J. (1978) "A Proposal for International Monetary Reform." *Eastern Economic Journal* 4 (July–October): 153–59 (http://cowles.econ.yale.edu/P/cp/p04b/p0495.pdf).
Tsang S.-K. (1998) "Handling Credit Crunch under Hong Kong's Currency Board System" (6 August) (www.hkbu.edu.hk/~econ/web987.html).
Willett, T. D. (1995) "The Plunge of the Peso: The Dangers of Exchange-Rate-Based Stabilization Policy." *Claremont Policy Briefs* No. 95–01 (February).
Williamson, J.; Griffith-Jones, S.; and Gottschalk, R. (2003) "Should Capital Controls Have a Place in the Future International Monetary System?" (2 May). Paper prepared for a meeting of the International Monetary Convention in Madrid (www.ids.ac.uk/ids/global/pdfs/Madrid3.pdf).
Yeager, L. B. ([1966] 1976) *International Monetary Relations*. 1st and 2nd eds. New York: Harper & Row.

Copyright of CATO Journal is the property of Cato Institute and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.