

Wanted: an International Exchange Rate Regime. The Missed Lesson of the Financial Crisis

Are international institutions able to learn? The world financial crisis which hit Asia and other countries around the globe in 1997 and 1998 is an extremely good example to test the case. The acute crisis is over. Most of the Asian countries are heading back to high growth rates. Korea and Malaysia are definitively out of the slump, Thailand is wavering but on a good track. Others are worse off: Indonesia is still in a mess and Japan has not yet found a solution for its deflationary depression. Brazil has turned the corner but Argentina has to fight with a huge overvaluation of its currency as the mirror opposite of Brazil's depreciation. Even Russia, which had been the most vulnerable of all the crisis countries, reported positive growth rates in 1999 – for the first time since the beginning of the transformation. What remains?

For many observers the financial crisis had been mainly a crisis of the banking system in the Asian countries whereas Russia and Brazil had to cope with other structural problems. But such a view raises more questions than answers. How were countries with a supposedly »rotten« banking and financial system like the Asian »Tigers« able to overcome such a severe crisis just by devaluing their currencies? How were they able to be so extremely successful in terms of catching up with the western world in the past? No region of the world, outside the part we today call the »western industrialized countries«, has ever accomplished such a long and stable phase of high growth rates as the Asian »Tigers« in the 1980s and the 1990s. How was Brazil able to survive most of the 1990s in good shape? How did Russia manage to achieve positive growth rates with its state owned monopolies? Why is Japan unable to escape?

The Japanese slump leads to the most important question: Why is it that very different countries have been the subject of a banking crisis? On the one hand we have seen the failure of countries with large current account deficits and competitive

weaknesses such as Thailand, Malaysia and Korea. On the other hand, and this is a neglected fact of the events which are called the »Asian Crisis«, there is Japan – a country which got into trouble despite having a very high current account surplus and without having fundamental competitive problems. The remedy for the acute crisis in the »weak« countries had obviously been a sharp devaluation of their currency vis-à-vis the rest of the world. In Japan it is just the other way round. The Yen was strong most of the time and in the first months of 2000 Japan faces a revaluation that is not justified by the »fundamentals« and that has to be fought by the central bank by buying foreign currency with Yen.

If a country has a weak currency because it has a »rotten« banking system, how can a country like Japan have a very strong currency although it seems to share the same weaknesses with regards to the financial structures and the banking system? Thus, the conjecture of a »rotten« banking system in Asia and of other »structural« problems around the world is not a convincing hypothesis. There must be other factors, beyond »rotteness«, which explain the problems of the banking system and there must be other factors which explain the crisis in different »structural« environments.

The Japanese Yen and the Way into Deflation

Japan's economy is in a deep crisis for the fourth consecutive year. Although there seemed to be the first signs of a recovery in the summer of 1999 the outlook remains rather bleak as there was a severe setback in the last quarter with overall GDP figures falling again. In the last years a lot of ideas have been launched to explain the persistent slump of an economy which, for decades, had been the role model for many »sclerotic« economies in the Western World. Most explanations of the Japanese

crisis focus on factors like a long isolated and inflexible banking system, the low profit margins of Japanese companies or the kind of cooperation between the government and the private sector which had indeed characterized the Japanese »model«.

The role of one factor, however, seems to be systematically underestimated: the exchange rate of the Yen. The Yen has wildly fluctuated in the last 20 years. However, erratic fluctuations are not adequate to describe what has happened in the beginning of that period. After the bubble in the stock and real estate market of the early 1990s had burst in response to a late but effective tightening of monetary policy, the exchange market entered the stage in an unprecedented and unpredicted manner. The nominal exchange rate of the Yen had already been overshooting the inflation and unit labor cost differentials with the rest of the world throughout the whole of the 1970s and the 1980s. The resulting real appreciation already falsified the traditionally held theory that the *real* exchange rate cannot have a trend. But after the sharp recession in the first two years of the 1990s things got even worse.

Between 1992 and 1995 the real rate of the Yen appreciated, according to different calculation methods, in a range of 50 to 100 per cent!¹ Not one of the larger economies in the world has ever suffered from such an appreciation shock on top

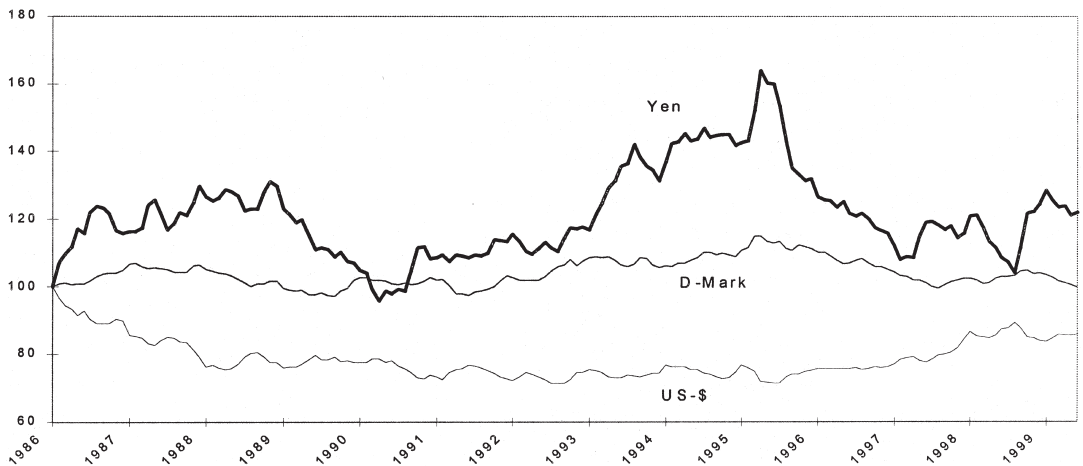
of a long phase of overvaluation. Germany, for example had a real appreciation of around 15% at the same time and was hardly hit by the consequent fall in export volumes, the loss of market shares and a rise in unemployment.

A shock such as occurred in Japan, would have led to a big crisis in every country of the world. Companies would have adjusted their labor force downwards, unemployment would have risen sharply, government deficits would have mushroomed. However, in Japan, despite the extraordinary dimension of the shock, neither a sharp drop in market shares nor a rise in unemployment can be observed. The growth rates of exports slowed down, but, according to OECD data, not even touched an absolute reduction. Employment stagnated but didn't fall. As unemployment hardly rose, the deficit in the public budgets increased slightly up to 1995, not even as much as in one of the major recessions in western countries. The shock is, however, clearly visible in non-residential fixed capital formation.

There is in my opinion only one explanation for such an outcome. Obviously, in Japan, companies, for a remarkably long time, stabilized the

1. The data in the graph are from the OECD and are based on consumer prices.

Figure 1:
Real Exchange Rate of D-Mark, US-\$ and Yen



system by bearing most of the unavoidable burden of the huge shock. Keeping the labor force, with the growth rates of total compensation per employee only coming down in small steps, means that the shock had to be absorbed for the most part by a profit squeeze. Such a profit squeeze would have led, again, under the auspices of a western system, to a sharp reduction of bank lending to companies due to much higher risk of default. In Japan, however, bank lending only stagnated at a rather late stage in the process. Close institutional relations of the banking system with the company sector and an insufficient supervision of banking activities have definitively played a role if we want to explain this kind of burden sharing. Only after the danger of major bank defaults appeared did the government have to step in and consolidate the banking system and thereby accept mushrooming budget deficits.

The conclusion of this analysis is not as simple as the one which is based on »structural« explanations of the Japanese crisis. Japanese or Asian institutional arrangements, i. e., the relationship between government, companies and banks, are not per se inferior to western ones. Given the size of the shock that the Japanese society had to absorb in one way or the other, any western economy would have tumbled, too. In western societies the government would have stepped in at an earlier stage and employees would have had from the beginning to shoulder a much larger part of the burden in terms of unemployment. In Germany, for example, the small, 15 per cent real appreciation induced a persistent debate about a fundamental loss of competitiveness and a lack of flexibility in the German society. With an appreciation of the Japanese size, most of the existing German institutional arrangements and achievements would have been put in question.

Thus, if adequate room is given in the analysis of the Japanese crisis to the external shock the Japanese economy faced in the first half of the 1990s the simple messages lose their persuasive power. Those who explain the visible weaknesses of institutions without taking into account the strain posed upon these institutions by external shocks, tend to overemphasize »structural factors« as well as »structural remedies«. This may lead quickly to an »overshooting effect« concerning the steps recommended to reform institutions.²

Collapsing »Tigers« and Other Challenges for the World Monetary System

The story of the slump in the rest of Asia is a bit more complicated and needs a bit more theoretical elaboration. The Asian countries had been under pressure from the West during the 1980s to liberalize their markets and thus to open their economies for goods as well as for capital. In consequence, these countries had to decide about adequate exchange rate regimes under open market conditions. In light of the experiences of some smaller countries in Europe and a number of newly industrializing countries with a successful stabilization of the price level in the short term, many international observers and advisers, including the World Bank and the IMF, recommended in recent years that emerging countries, including the Asian »Tigers«, should employ a fixed exchange rate vis-à-vis Western countries. The nominal exchange rate would then serve as the nominal anchor, giving incentives to all sectors of the economy to adjust their nominal claims to the conditions prevailing in the Western world. Even for large transition economies like Russia, Ukraine, and Kazakhstan this was considered by the IMF and others to be a reasonable strategy. The strategy, the proponents argued, should render the steering of monetary policy and the stabilization of inflation rates easier in countries where the credibility of the central bank is not sufficient to keep a check on inflation in the short term. In the extreme case of the so-called currency board or a full dollarization, monetary policy is deprived of any scope for autonomous action.

The strategy of anchoring a national currency by fixing its nominal rate vis-à-vis a big and stable

2. The reasons for Japan's failure to overcome the deflationary depression are manifold. Nevertheless, one reason stands out: Japan is the only country in the »Western« world in which nominal wages have been falling in absolute terms. Falling nominal wages, in stark contrast to textbook models, in reality do not lead to rising employment but to falling demand and, as a consequence, to falling prices. As monetary policy cannot offer negative interest rates economic policy is restricted to fiscal stimuli. But these are compensated in the case of Japan by an appreciation of the Yen. Thus, the only way out is inflationary policy not only by means of monetary policy but also by means of some kind of wage policy.

country has found many supporters in Asia, too, because it seemed to offer another major advantage compared to domestic solutions. Investment, according to the basic tenet of the school of thought which dominates the IMF and the mainstream of economics today, depends on the prior accumulation of savings. These, however, due to relatively low levels of income are too small in emerging economies. In Asia the ratio of investment was high. Nevertheless, there seemed to be a scarcity of capital which could be healed by opening the borders. But in order to get the »necessary« inflow of foreign capital, stable monetary conditions would be needed and anchoring the exchange rate would create them. More and more countries therefore turned to the strategy of pegging their exchange rate to some lead currency, just as Austria, for instance, had successfully linked the Schilling to the German Mark for decades.

If such a strategy of pegging the exchange rate is adopted, the nominal interest rate is set so as to render – after adjustment for any differences in the rates of inflation – approximately the same real interest rate (which is the crucial quantity for fixed investment) as in the anchor country. If the anchoring country offers higher returns on invest-

ment, because the productivity of capital is higher there, the process of catching up becomes possible. But, exactly at this stage of affairs, the monetary conditions, the combination of nominal interest rates and exchange rates are in disequilibrium.

Let us look at Korea, one of the countries in which there had been a successful catching-up for decades and which collapsed suddenly in the new environment of open markets and fixed exchange rates. The relevant data are in figure 2: Korea started fixing the nominal rate more or less in 1992. At that time the real interest rate for a Korean company searching for a loan in Korea was at 8 per cent and thus quite close to the real growth rate of the Korean economy. But the real rate for a loan obtained in the United States was very low, namely close to zero, because *nominal* interest rates in the States were much lower than in Korea. Conversely, for an US investor the real interest rate offered in Korea was close to 10 per cent and thus much higher than in the States. Proponents of the »nominal anchor approach« usually overlook the fact that foreign investors can take advantage of de facto short-term arbitrage opportunities if everybody calculates real interest rates by deflating with his *domestic* inflation rate.

Figure 2:
Real Interest Rates in the USA and Korea



This is reasonable as in the short term purchasing goods is not necessarily related to an act of lending. The differential of nominal interest rates between the countries under consideration corresponds to the one between inflation rates. But the inflation rate in Korea is of no concern to the US investor, as he calculates with his domestic inflation rate. For him it is important that the rate of return he can earn with financial assets in Korea exceeds the one he could earn at home – if he deflates both by his domestic inflation rates. However, this only works out if there is no risk of devaluation. As the anchor approach rules out such risk in the short run it prepares the ground for profitable interest-rate arbitrage.³ This also holds for Koreans who borrow in the United States. They can take advantage of lower US nominal interest rates without an exchange-rate risk. Thus, we get a permanent flow of foreign capital to Korea. A large part of it is of the speculative short-term kind. Also, domestic banks and companies borrow much more abroad than they would if the risk of a depreciation would not have been eliminated de facto.

However, wages, unit labor costs and prices rise faster in newly industrializing countries than in the hard-currency countries. Therefore, the currency of the anchoring country keeps appreciating in real terms, the country loses competitiveness. As a result, the inflow of capital will be mirrored by corresponding deficits in the current account.

How long an external economic imbalance following the exchange rate peg can be sustained is an open question. With growing visible imbalances the markets' willingness to believe in the anchoring country's exchange-rate policy will fade. As soon as investors are convinced that the anchoring country will not manage to slow down the growth of its external debt within an adequate period of time, confidence in the exchange-rate's stability deteriorates. Fearing the ultimately inevitable devaluation of the currency, foreign investors withdraw their short-term funds and domestic companies stop borrowing abroad. This will cause liquidity shortages at home. At the same time, increasing amounts of this country's currency are offered for sale in foreign-exchange markets which forces policy makers to restrict liquidity even more. Sooner or later, policymakers have to abandon the exchange-rate peg, which is usually fol-

lowed by a currency crisis.⁴ Enormous dislocations in all sectors of the economy are the result. The problem may be aggravated by close ties and cross-holdings between banks and non-financial business, the government's too hesitant withdrawal from the financial sector, insider lending, adverse selection and moral hazard, but the core of the problem has been the anchor strategy.

The economic situation in Non-Japan Asia was not as extraordinary as many observers believed in the first round. Given the heavy exposure of domestic companies in foreign markets, the sharp depreciation of the exchange rates would under any »structural« conditions have led to enormous problems with the bank's balance sheets. That in Europe similar problems could have been avoided in the past has two reasons. Firstly, there was usually a »safety net« for devaluation as most of the devaluations had taken place with members of certain currency systems, such as the EMS. Secondly, an expectation about a certain »necessary« amount of depreciation of the weak currencies had always been in the markets as the differences in nominal exchange rates between countries in a similar stage of development could not have been interpreted as a good bargain but as an early warning of a coming depreciation. Nevertheless, even in Europe there were big devaluations accompanied by banking problems. Sweden in the 1990s offers an example. But there is virtually no case where, after a rather long period of exchange rate stability, a currency lost half or more of its value within a short period of time.

3. An extreme example is Russia where under the supervision of the IMF nominal interest rates reached something like 50% and real domestic rates even 20% in the phase of transition and at the beginning of an anchor approach. Accordingly 3-month Russian government bonds (GKO's) have been highly attractive for international investors for over two years.

4. Given the very often unreliable data, a simple but straightforward rule to identify a coming exchange-rate crisis or a collapse of the real economy in an emerging market is the following: If nominal short-term interest rates in a developing or transition economy are higher than in industrialized countries and the nominal exchange rate of the former does not fall at a (annual) rate that equals the difference in (annual) interest rates then the constellation of data is not sustainable as either the interest rates or the exchange rate are too high in the emerging market.

In the long run, emerging economies can avoid such an outcome only if they succeed in the control of inflation. This means that they have to implement wage and income policies comparable to those in the country whose currency they prefer to pick as an anchor. But there have to be solutions for the phase of transition. There are two ways out: firstly, an anchor approach with controlled devaluation or, secondly, a crawling peg.

The anchor approach is not a priori unreasonable. Countries may be unable to stabilize the domestic and the external value of their currency at the same time because the government may not be strong enough to implement a strategy which is based on domestic measures alone. Italy was a striking example in Europe of the helpful pressure exerted by external restrictions. Brazil, too, was only successful with its plan to stabilize the Real after the anchor approach had been adopted. But policy makers have to be aware of the dangers inherited with such an approach and there has to be a plan to safeguard the currency from falling beyond any reasonable limits if the unavoidable, depreciation, is bound to happen.

The crawling peg, too, has advantages as well as disadvantages. The crawling peg aims at keeping the emerging country's exchange rate constant in real terms. The exchange rate does not follow the interest rate parity but the purchasing power parity even in the short run. Real-world examples are most of the Eastern European countries which are in a stage of transformation still. The best example seems to be Hungary. The country has managed to stabilize the real rate of the Forint for several years now without being subject to speculative attacks from the markets. But the crawling peg does not offer any help concerning pressure on domestic inflation. Economic policy has to be smart enough to bring down domestic inflation by means of monetary policy and/or wage policy.

A policy of controlled flexibility of the exchange rate, be it a crawling peg or an anchor approach with controlled depreciation, will not induce immense capital inflows from abroad. Still, controls on the flow of capital might have to be considered in order to safeguard an anchor approach. Even though this involves problems of its own, it does not preclude the implementation of a successful strategy of development. Invest-

ment activity does not depend on the existence of accumulated savings at home and abroad. Investment generates higher profits and higher incomes and automatically encourages bigger savings. Important is a favorable monetary environment for investment.⁵

Corner Solutions Versus Controlled Flexibility

The lesson international policy on the G-7 level has drawn from this experience of the 1990s seems to be very simple: If a country is able to permanently peg its currency vis-à-vis an anchor country and to avoid a real appreciation, well and good. This is the case of Argentina which is backed by almost all international observers including the United States. If it is unable to do so, there is only one solution left: flexible, i. e. market-determined exchange rates. This is the doctrine of the »corner solutions« which is the final lesson the US-administration has obviously learned from the world financial crisis beyond the mist of the so-called »world financial architecture«. But this doctrine is nonsense. The European Monetary Union could only be built because nobody had ever considered an immediate corner solution in the first 20 years of its evolution. In other words, not one of the countries which are now members of the EMU has ever considered to jump from one corner to the other. Each of them had a transition phase of controlled flexibility, i. e. fixed but adjustable rates.

Illuminating is the case of Poland since the middle of 1999. From July 1999 to March 2000 the Sloty had climbed by more than ten per cent in nominal terms against the Euro despite an annual inflation of ten per cent in Poland. Polish exports were down more than 13 per cent year-on-year in the first two months of 2000 and imports were up. Monetary policy was rather tight with short-

5. See for a monetary theory of development: H. Flassbeck, Die »Weltwirtschaft zu Beginn des 21. Jahrhunderts und die Herausforderung für den Westen«, in: Burkart Lutz, zusammen mit Mathias Hartmann und Hartmut Hirsch-Kreinsen (Hrsg.): *Produzieren im 21. Jahrhundert. Herausforderungen für die deutsche Industrie. Ergebnisse des Expertenkreises »Zukunftsstrategien«*, Band 1, Campus Verlag, München 1996.

term interest rates at more than twelve per cent in 1999, given an inflation rate of around seven per cent⁶.

The attractiveness of the Sloty is easy to understand. Nominal rates were always much higher in Poland than say in Germany. As long as there are no acute crisis symptoms in the Polish economy and as there is thus no acute danger of a depreciation of the Sloty vis-à-vis the D-Mark, it is rational to invest in short-term notes in Poland. For Polish investors, on the other hand, it is rational to borrow in Germany or Euroland if they have access to these markets. Thus, after the end of the world financial crisis in which the Sloty had to depreciate, too, the flexible-exchange-rate »solution« was appreciation of the Sloty and not depreciation. In other words, in the short term, the interest-rate parity theory holds whereas the purchasing-power parity theory does not.

It is striking how naively, in the aftermath of the world financial crisis, Polish officials comment on the strength of their currency. The Financial Times reports that the central bank points to the effects of a tight monetary policy on consumer borrowing and that »economists« believe that the country's hard currency reserves are high enough to »easily« withstand an attack on the currency. But these are not the critical points. The question is whether one *should* withstand an attack and how to avoid an overshooting in case of a justified attack. No country in the world can permanently cope with an overvalued currency. The real challenge for policy makers, as the Asian crisis has shown in unprecedented clarity, is not to avoid the crisis but to contain its effects, inside and outside the country, to within reasonable limits. There are no reasons to believe that the system of flexible exchange rates will bring about a rational solution sooner or later. The »solution« will be a crisis because this system, given the huge incentives to invest as long as possible in the wrong direction, i. e. against purchasing-power parity, can only turn around in panic. The costs of such a »solution« are extraordinarily high as the allocation of resources is distorted before and after the crisis in a manner which by far outweighs the costs of changes in the internal value of money.

In fact, one of the most striking inconsistencies of modern economics is the different weight it gives to the domestic value of money on the

one hand and to the external value of money on the other. Whereas the stability of the value of money in time (price stability) seems to be the most important feature of any type of market economy, the value of money in space (stability of the exchange rate) seems to be not important at all. But if strong and unpredictable fluctuations of the value of money in time lead to the kind of misallocation of resources which is attributed to it, the observed fluctuations of the value of money in space must be at least as disastrous as hyperinflation-type movements in the internal value.

These considerations are by no means new. Already in the 1950s and 1960s, the same dilemma was the subject of a debate concerning England.⁷ When capital is free to flow between countries, a system of floating or flexible exchange rates will ultimately be unable to reduce the need for adjustment. It will even be the other way round: Flexible exchange rates may make an investment in a developing country more attractive in the short term as a nominal appreciation adds to the attractive interest rate. This is definitely true for all periods in which the purchasing-power-parity theory does not hold and interest-rate parity dominates. Developments following this pattern can be observed in many Eastern European countries in the first phase of their transformation.

With open capital markets there is ultimately no alternative to adjusting the rise of prices and

6. »Poles find strong currency can be a mixed blessing« in: *Financial Times*, April 7, 2000.

7. J.R. Hicks wrote in 1968: »To adjust the value of money as a once-for-all measure to meet a single identifiable change (such as that caused by a world war) seems to me to be one thing, a continuing failure of competitive power, to be quite another. If currency depreciation is adopted as a regular policy people must come to foresee it. If they do so, they will decline to hold the depreciating currency; for it is more profitable to hold a stable money than one which is depreciating. Even though the »soft« currency is fortified by exchange restrictions, the objection is not wholly met; for it is doubtful if any practicable exchange restrictions will suffice to protect a currency, depreciation of which has become a habit. In our own case, in view of the advantages which we gain from the use of sterling as an international medium, this argument is particularly powerful. We may be put to great strains in order to maintain the exchange value of sterling (at least to the outsider), but I doubt if we have any alternative but to bear our cross.« J.R. Hicks (1968): »The Long-Run Dollar Problem«. In: R.E. Caves/H.G. Johnson (ed.), *Readings in International Economics*. Homewood (pp. 441–454).

hence of money wages. For a while, flexible or adjustable exchange rates may eclipse the necessity of adjustment, but no monetary system can completely eliminate this predicament. Countries which are candidates for a devaluation of their currency, that is, countries with deficits in their balance of payments, or countries with chronically high inflation rates will have to adjust sooner or later. Otherwise they will get caught in a spiral of devaluation and inflation again and again. They can only avoid this if they finally manage to create the kind of domestic conditions that would also be required by a system of absolutely fixed exchange rates or a currency union. This means that the free flow of capital can only be guaranteed if unit labor costs and prices do not rise faster at home than abroad. Otherwise, various types of currency crisis, or restraints on the free flow of capital, will prove to be inevitable.

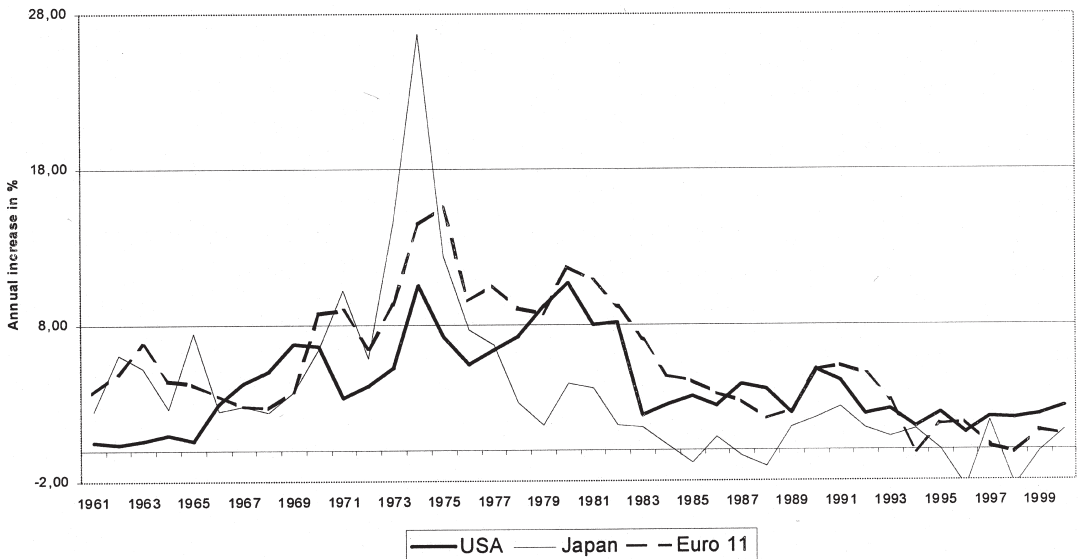
Euro, Yen and Dollar

However, nominal convergence is only the necessary and not the sufficient condition for a stable international monetary environment. The degree of convergence within the G-3, the group of large industrialized economies is impressive.

Nevertheless, the degree of exchange rate stability is much less impressive. Although Japan and the Euro 11 have achieved absolute stability of their domestic monetary conditions for a very long time, their currencies are the subject of speculative attacks in different directions and there is no cooperation within the G-3 to improve the functioning of the global monetary system.

Even the opposite is true. During the summer of 1999 the Japanese government, for example, was heavily criticized by Larry Summers, the Treasury Secretary of the United States, for intervening in the exchange market to avoid a further appreciation of the Yen against the US-Dollar. Instead of leaning against market forces, the Japanese government should rather concentrate its efforts on a stimulation of domestic demand. At that time Summers was known to have also criticized the Europeans – time and again – for not stimulating their domestic demand, given their high current account surplus in 1998 and sluggish growth throughout the 1990s. Not mentioned, however, in the case of Europe was the fact that the Euro depreciated sharply vis-à-vis the US-Dollar, thus reducing the need for Europe to stimulate domestic demand as they could expect to export their way out of the slump.

Figure 3:
Nominal Unit Labor Costs (in national currency)



The US Secretary of the Treasury criticized Japan's attempt to block an appreciation of the Yen although the Japanese government had been working very hard in the last two years to stimulate domestic demand. But he refrains from asking the Europeans to prevent a depreciation of their currency although Europe has not worked hard at all to stimulate domestic demand. This reveals a strange asymmetry in the argument. Given the fundamentals in Japan on the one hand and Europe on the other hand, both currencies are clearly candidates for an appreciation vis-à-vis the US-Dollar. Actual inflation differentials as well as expectations concerning future inflation differentials which can be derived from actual growth differentials, are clearly not in favor of a strong Dollar. The high overall current account deficit of the US and the bilateral deficits with both partners point in the same direction. Only interest rates are higher in the States than in Japan and Europe. But if this is taken as an argument the much higher differential with Japan, seen from the US, could only lead to an even more pronounced devaluation of the Yen, not a revaluation, if such a differential were to justify the decline of the European currency.

Two currencies with fundamentals pointing in the same direction but de facto moving in opposite directions give economic policy no rational choice. Leaving the exchange rate to the market obviously yields contradictory results. If the Yen is not stopped from rising, the Japanese recovery will falter and thus render much more difficult the job of the Japanese government to stimulate demand and help to bring down the global disequilibria in trade. Fortunately for Japan, to stop the rise of the Yen and to give domestic demand a boost via monetary policy are not directly in conflict. This is much more difficult in Europe. If the Euro is stopped from falling by means of monetary policy, e.g. rising interest rates, it may be impossible to stimulate domestic demand. But if the Euro is not stopped from falling European economic policy will not be forced to stimulate domestic demand at all but will again take a free ride on growing exports thereby aggravating the global imbalances in trade. A consistent strategy of the G-3 is without a chance as long as the US sticks to its general dogma of leaving the determination of the exchange rate to the markets.

When questions like these were raised in 1999 by the former German finance minister Lafontaine, the US answer was stereotypical. Secretary Rubin said that from his point of view it would never be reasonable to raise interest rates in a recession just to defend a certain parity, i. e. avoid a depreciation of the US-Dollar at the high price of deepening the recession. This is an absolutely convincing argument if it describes the relevant situation correctly. But, as illustrated by the Yen case and the Euro case, it may be fully beside the relevant point if the exchange rate does not follow Rubin's theory but rather a random walk. The question currently asked in Japan is: How can a deepening of the recession or a renewed slowdown be avoided as monetary policy, due to interest rates already close to zero, has lost its strength and the currency is nevertheless under the pressure of markets to appreciate – not depreciate? There is obviously no answer in either Rubin's or Summers' theory to this question. Exchange rates, left to the market, do not follow rational paths of adjustment or even facilitate rational decision-making by economic policy. Sometimes, by chance, they may help to complement monetary policy in a certain cyclical situation. But as this cannot be expected in a systematic manner there is virtually nothing that can be left to the market alone.

There are also effects on the allocation of resources. The relative price between tradable and non-tradable goods in every country is changed at the same time as the price between domestically produced and foreign goods is altered. Europe's recovery today is based to a very large extent on the effect of a depreciation instead of demand stimuli from economic policy, the overall outcome on production in the European economy may be similar to the one that can be achieved by lowering interest rates. But the necessary by-product of an exchange-rate-based strategy in Europe is an increased profitability of exportable goods compared to non-tradables such as services. The opposite occurs in the United States. In the medium and long run it will become even more important then to turn around this kind of development.⁸ Thus, the larger the misalignment

8. See Heiner Flassbeck: »In the long run... ist der Dollar schwach.« in: *Financial Times Deutschland*, 16.3.2000.

today the more probable is a full swing in exchange rates later with all its complementary negative effects on investment in fixed capital on both sides of the Atlantic.

The US Government will learn the importance of these considerations as soon as growth rates plummet under the burden of higher exchange rates plus higher interest rates. The Euro seems to follow the example of the D-Mark at the beginning of the 1980s when, in comparable cyclical circumstances, the D-Mark was under pressure for more than three years when the rate of the D-Mark vis-à-vis the US-Dollar nearly halved in a very short period of time. The US Government will react as soon as the overvaluation of the US currency is felt in terms of a weakening of the economy. It is only due to successful macroeconomic policy in the 1990s that up to the present a benign-neglect approach of the US administration seemed to be feasible. But the bubbles, including the one that is blowing up between Dollar and Euro, will burst. Only an early cooperation between the G-3 can help to avoid what will later be called a major misalignment with all its repercussions on the real economy. The lesson of the 1980s is a simple one: There can be preemptive strikes by international monetary policy to avoid unjustified changes in the external value of money and this is justified as the effects of these changes are at least comparable to the effects of dramatic changes in the domestic value of money (unanticipated inflation or deflation).

Why is it that the market for currencies misaligns time and again whereas we believe that all the other markets, the markets for everyday consumer goods as well as those for extremely expensive investment goods, work effectively? A radical liberal thinker, F.A. Hayek, has led the way towards a solution. According to Hayek's theory of markets, the goods markets are efficient because on these markets millions of participants collect trillions of individual information units which determine the prices of a huge variety of goods. A government can neither collect nor process this information reasonably and thus cannot produce prices which adequately reflect scarcity. The market for currency is organized in a quite different way. On this market, information is collected which stems mostly from government sources like statistical offices or central banks. This information is interpreted in a certain way by, even on a global

scale, only a few traders. They try to match the views which, like in a beauty pageant, are seen as best representing the views of the majority of traders. The aim of the game is not to buy the product because it is needed to produce or sell something that forms part of an individual act of profit-making but to make the highest profit with the best forecast of the final outcome of the game.⁹

That is not to say that exchange rate changes in the global economy are not needed any more. If convergence of the monetary conditions, i.e. the convergence of inflation rates, is not yet achieved, exchange-rate changes should reflect the resulting differences adequately to equilibrate the competitive positions of regions or nations. But if convergence is given, as in the European Union, and the participating nations have the stamina to stick to their obligations in terms of preserving their competitive level without relying on changes in the value of money, the exchange rate is unnecessary. With the entry into European Monetary Union Europe has achieved an extraordinary success. It has closed one of the biggest casinos in the world and time will prove that this was a rational decision. But the rest of the world is not terra incognita. The European achievement will only be a half-way house if it is not complemented by more monetary cooperation on the level of the G-3 and regional arrangements between the G-3 and the emerging markets which pave the way for the closure of the other casinos in due time.

If the world economy aims at avoiding huge fluctuations in the external value of money and at allowing a very high degree of capital mobility, a close cooperation of the big players' central banks and/or a formal exchange-rate regime are the only way out. Europe has reached the corner solution of absolute fixed exchange rates. This solution requires a high and permanent convergence of the monetary conditions, i.e., mainly of unit labor costs and prices. But for countries which are not yet able to guarantee this level of nominal convergence, there must be solutions between the »corners« of fully flexible or fully fixed rates or the world will tumble from crisis to crisis. ◀

9. As a consequence, Hayek clearly opposed flexible exchange rates and favored an international standard. He laid down his position in a more or less forgotten, but nevertheless extremely important book in 1937. Cf. F. A. Hayek: *Monetary Nationalism and International Stability*, A. M. Kelley, New York 1971.