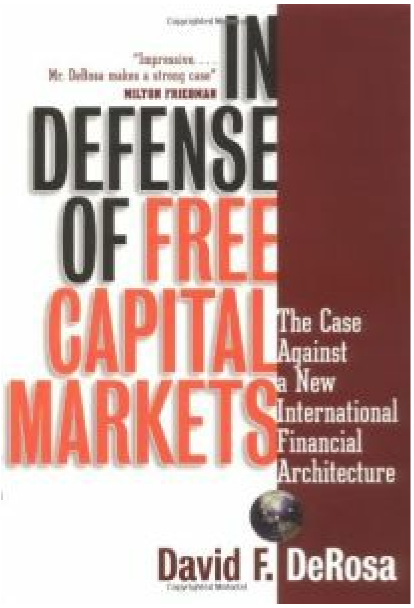

Book In Defense of Free Capital Markets

The Case Against a New International Financial Architecture

David F. DeRosa
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Recommendation

Yale University adjunct professor David F. DeRosa argues that markets are smarter than government ministries. Therefore, he contends, economic development should be left to the free market, since tighter regulations will only distort development. His detailed analysis of economic conditions focuses on factors leading to several crises, including the decline of the Mexican and Japanese economies in the 1990s and the Southeast Asian collapse of 1997. The subject is complicated and interesting, and the writing is often technical and sometimes complex.*BooksInShort* calls this book to the attention of scholars, executives and managers who have a serious interest in fiscal policy. And we do mean serious.

Take-Aways

- Economic crises ravaged Mexico, the European Community and much of Southeast Asia during the 1990s.
- After three decades of high growth, Japan's economy declined in the '90s.
- The worst financial crises of the decade occurred in countries with fixed exchange rates.
- Setting its currency exchange rate is a country's most important financial policy decision.
- Many countries set fixed exchange rates in an effort to stabilize currency markets.
- Fixing rates often has the opposite effect, since exchange rates fluctuate to achieve equilibrium balances in the world economy.
- These crises illustrate the need for a free market where prices move freely.
- The rationale for this free market approach is that exchange rates are prices and they fluctuate for a purpose.
- As conservative economists contend, a free-market economy functions more efficiently.
- The ultimate causes of the financial crises during the 1990s were the failure of government regulations and poor financial policy.

Summary

The Financial Crises of the '90s

The failure of government regulation coupled with faulty fiscal policies caused the financial turbulence of the 1990s. A free-market economy works better, according to conservative economists, beginning with Adam Smith two centuries ago. As they consistently point out, a free-market economy - one that is unburdened by central economic planning and affected by only light government regulation of supply and demand forces - is the most efficient and reliable economic system. The 1990s saw a number of financial crises, including stock market crashes, exchange-rate problems and serious economic contractions, which led many people to question free markets. However, these crises were due to flawed government policies that interfered with free market operations.

> "The (economic) problems of the 1990s came not from outside but rather from within. Disaster was homegrown and the natural consequence of wholly ruinous domestic policies."

One crisis occurred in Japan, which had experienced three decades of high growth through the 1980s. Then, in 1990, the country's stock market suddenly declined; drops in real estate, banking and other sectors followed. Europe experienced currency crises in 1992 and 1993; Mexico had a peso crisis in 1994. The Southeast Asian currency crisis that created financial chaos in 1997 preceded Russia's default and devaluation of the ruble in 1998 and Brazil's currency depreciation in 1999. While these were the major 1990s low-points, overall economic dislocations leading to "currency crises, stock market crashes, deflation, recession, sovereign insolvency and political instability" characterized the decade.

Flawed Financial Policy

The roots of these crises can be traced to flawed financial policy, particularly to faulty decisions about national currency exchange rates, since this is the most important financial policy decision a country can make. Unfortunately, many countries implemented fixed exchange rates to stabilize their currency markets. But that choice has not led to stability. Instead, fixed exchange rates have led to extreme economic changes. Many countries with fixed exchange rates have had major crises, including Mexico, Thailand, Indonesia, Russia and Brazil. In fact, when the U.S. dollar rose in value, the shift vastly increased Asia's dollar debt amount - a major factor leading to the currency sell-off in Southeast Asia in 1997. Japan sought to support its bond market by having the government and its agencies buy bonds. Then, it made the mistake of raising its national sales tax in 1997, which interfered with the beginnings of the Japanese recovery that year.

> "Fixed foreign exchange rate systems, but not floating systems, are in fact the breeding grounds for great financial crises."

Many political leaders and economic ministers don't realize that the root causes of their 1990s problems reside in underlying economic factors and their own domestic policy errors. Instead, they blame the free-market system, claiming that a negative financial outcome is the natural result of a system where capital can move freely between borders. Thus, they think that tinkering with their international monetary policy will prevent further financial woes.

> "Financial crises largely can be explained by looking at the domestic policies that ministries of finance and central banks have laid out for their own countries."

However, in reality, they are unfairly blaming the market and its hedge funds, capital flows and aggressive foreign-currency traders. The real culprits were "ruinous domestic policies," especially the decisions in Mexico, Thailand, Indonesia and other countries to create various "fixed exchange-rate regimes." The floating currency rate adopted by South Korea and most Southeast Asian nations contributed to their recoveries. Ironically, though, most government officials don't credit the market forces for helping to repair the damage caused by past policies. Instead they seek new financial market regulations.

> "The single most important financial policy decision that a country makes is its choice of which exchange rate regime to establish for its currency."

Governments want new regulations because they want to be more integrated into the marketplace. Ensuring that everyone complies with new rules creates a large monitoring industry. So lawyers, bureaucrats and officials become wedded to regulations and then must blame others - such as stock market traders and those involved in hedge funds and index arbitrage - for market manipulation. Governments have sought to demonize the foreign exchange market more than any other market.

> "In many cases, at least in the history of the '90s, policy can be shown to have exacerbated the upheavals."

Much of this hatred occurs because few heads of states really understand economics. Most come from law or some other background, so they don't realize that prices, including exchange rates, are a natural way of regulating resources in the face of competing demands. Even many finance ministers and bankers may respond to foreign exchange markets in an adverse way due to political considerations and the influence of popular opinion, which views these markets as sources of speculation. When the market is left to function freely, prices will adjust to the correct supply and demand in all markets, regardless of whether the product involved is food, labor, stock prices or foreign currency.

> "Practically all of the episodes of financial crisis in the '90s occurred in countries that had fixed exchange rate systems."

This correction requires recognizing that normally functioning markets should be free to allow prices to move up and down. In turn, investors deal with these normal fluctuations through derivative contracts, the main tool investors use to hedge their risk in foreign exchange markets. Such contracts include both forward foreign exchange contracts and options on foreign exchange. However, in a fixed exchange regime, where the exchange rate can make sudden sharp breaks, dealers can't afford to engage in hedging contracts, which discourages investors and contributes to the economic disintegration in these countries.

Financial Problems in Japan

Japan, Europe and Southeast Asia illustrate the problems caused by failed domestic financial policies in the 1990s. The collapse in Japan was a particular surprise, since Japan rose from its devastation after World War II to become the world's second-largest economy. It went through a period of spectacular growth from the 1960s to the 1980s, and some believed it would become larger than the U.S. economy. Herman Kahn of the Hudson Institute think tank, predicted decades of great growth, due to Japan's emphasis on education, worker loyalty and the national "propensity to save." Then, Japan went into a sudden downward spiral characterized by stagnation and financial ruin.

> "The big picture for this troubled decade (the '90s) can be summarized as this: parts of Europe, Asia, Russia and Latin America experienced currency crises, stock market crashes, deflation, recession, sovereign insolvency and political instability all rooted in economic dislocations."

The Japanese government's major role in making economic decisions was a key reason for Japan's decline. A centrally planned system lacks the ability to create individual rewards to motivate everyone to practice efficient economic behavior. It is essentially a "mixed, pseudo-capitalistic system." In the late 1980s, Japan became a bubble economy, especially between 1986 and 1990, when asset prices skyrocketed, increasing two or three times in value. Permissive monetary policy produced inflation in the late 1980s. The bubble burst when the Bank of Japan suddenly reversed this permissive policy in late 1989. The Bank thought the dollar had fallen too fast; it bought dollars and raised interest rates. Concurrently, the Ministry of Finance raised the capital gains tax on land speculation. The economy abruptly stalled, the stock market plummeted and the real estate market followed. The banking system froze. This began Japan's 10-year decline to a zero-growth economy.

> "Many fixed rate regimes have failed in their intended purpose of maintaining stability in the currency market. Quite the opposite of what was intended, fixed exchange-rate regimes can cause violent macroeconomic fluctuations."

Japan's problems were followed by declines in two other fixed-market regimes: Europe and Mexico. This currency crisis, sometimes called "an exchange-rate regime crisis," was due to distortions that gave the currency artificial stability, until market pressure forced these countries to devalue their currency or abandon their fixed exchange rate regime.

> "Japan made a crucial error in judgment in April 1997 when it decided to raise its national sales tax. Critics of then Prime Minister Ryutaro Hashimoto believe his insistence on raising the tax was responsible for materially obstructing a nascent recovery in Japan."

These basic distortions from fixed exchange rates occur because once a country fixes its exchange rates, it has to tell its central bank to buy or sell its currency at that established rate, under which the currency's value is set to another country's currency (the "reserve currency.") To make this exchange possible, the central bank has to withhold foreign reserves, including bonds and foreign currency. This situation can lead to great instability due to fluctuations in the domestic interest rate and exchange rate, creating an imbalance between the fixed exchange rate and the true market rate. As a result, the central bank may have to devalue or lower the fixed rate, for instance, if the domestic economy is performing poorly.

European Exchange Rates and the EMS

Such developments led to the European exchange-rate crises in 1992 and 1993. The creation of the European Economic Community in 1957 - leading to the establishment of the European Economic Monetary System (EMS) in 1979 - was a very ambitious experiment in fixed exchange rates. It included the creation of the European currency unit (ECU), which was based on weighing the average of all EMS currencies as of 1979 and periodically adjusting exchange rates based on the relative GDP of EMS members. This was supposed to stabilize European exchange rates, but it had high volatility, requiring 18 realignments between 1979 and 1999. Exchange problems triggered two currency crises, which were exacerbated by the different interest rates of the currencies involved. In 1992, the German central bank repeatedly upped the short-term interest rate to respond to a growing budget deficit after unification with East Germany. Since this was the central anchor bank of the EMS, its actions spread Germany's economic problems throughout Europe.

Mexico and Southeast Asia

Fixed exchange regimes also triggered crises in emerging-market economies, notably Mexico and most of Southeast Asia. These countries ran huge current-account deficits, which were rationalized at the time on the grounds that such fast-growing economies needed a great deal of foreign capital. However, the high level of investment created inflationary pressures and overvaluation. A loss in investor confidence started a crisis, and these countries lacked sufficient foreign reserves to cover the financial decline. In Mexico, the crisis also was triggered by a loss of confidence in political stability as the Chiapas disruptions increased and a PRI presidential candidate was killed. When the government issued a tesobono bond linked to the dollar, the peso's value declined even more as the value of government debt increased.

> "Large amounts of capital flowed into every crisis nation in the year or two before its collapse. But for governments to moderate capital flows, even assuming that this is what needs to be done, would require the imposition of a rigid structure of global capital controls."

In Southeast Asia, the economic decline began in the summer of 1997 with the selling of local currencies in Thailand. It spread to the Philippines, Malaysia and Indonesia. Soon stock and real estate prices dropped dramatically and financial insolvency spread through the region. Regional authorities incorrectly blamed currency and stock market speculators, especially hedge funds. Instead, major factors included China's devaluation of its currency by 50% in 1994 (in order to expand its exports) and the strong-dollar policy pursued in the 1990s by Japan, Germany and the U.S. The reduction of the dollar's value against the yen to overcome the problem of Japan's high level of exports to the U.S. and the later reversal of this move created a credit crunch, because the Southeast Asian countries had bought up debt in devaluated U.S. dollars. Once the dollar's value increased so did their debt, which led to the foreign-exchange crisis that precipitated economic disaster.

A New Financial Architecture?

These crises illustrate the need for a free market. Although the countries affected in the 1990s want to think their problems come from somewhere else, the problems are domestic. For instance, Singapore weathered the financial storm effectively with little damage because it had more flexible policies with a high degree of capital mobility.

> "Derivatives are the principal tool that investors use to hedge foreign exchange risk."

In short, with only a few exceptions, the financial turmoil of the 1990s was due to a breakdown in the fixed exchange-rate arrangements in these countries. Countries should respond to these situations by having a floating exchange rate. This way the currency can respond freely to market forces and correct itself. Exchange rates are prices and, as such, play a vital role in achieving equilibrium balances in the world economy. If rates fluctuate, then it is for a purpose. Putting artificial constraints on the movement of exchange rates undermines the proper workings of the world economy. Even short-term government interventions to create "managed floating regimes" can be disruptive. Let the market prices adjust naturally.

About the Author

David F. DeRosa , Ph.D., is the president of DeRosa Research and Trading. He is an adjunct professor of finance and a fellow of the Center for International Finance at the Yale School of Management. He writes a column on international finance and politics for Bloomberg News.