

Exchange Rate Regimes and Capital Controls

Matias Vernengo and Louis-Philippe Rochon

Challenge periodically presents essays on the current intense debate over exchange rates. These two economists make a case that the principal concern is capital controls: They are needed to maintain full employment policies.

THE recent turmoil in the world's financial and currency markets has prompted cries for innovative ways of dealing with uncertainty and capital flows. In the last couple of years, the troubled Asian and Russian markets and the more recent Brazilian instability have only revived a long-standing debate on the merits of flexible versus fixed exchange rate regimes. In its recent Survey on Global Finance, the *Economist* argues that certain policy inconsistencies in the face of the recent turmoil result from "deep divisions about exchange rate regimes among economists" (1999, 15).

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We believe the divisions concerning exchange rate regimes are of secondary importance. The main difference among economists resides in their views on the objective of economic policy. Preferences over a specific exchange rate regime can be linked to macroeconomic policy, in particular to whether economists prefer full-employment policies or whether they defend policies aimed at guaranteeing price stability. In this sense, the all too

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familiar dichotomy between Keynesian economists (full employment) on the one hand, and neoclassical-monetarist economists (price stability) on the other, is also an appropriate one. In this sense, Keynesians and monetarists alike have switched their allegiances over the years from one regime to another, depending on whether, given the specific institutional settings of the time, fixed or flexible regimes were better suited to reach their respective policy prescriptions.

Also, we believe that progressive economic policies in a stable environment require the reintroduction of capital controls. By that we mean more than throwing sand in the wheels of the international monetary system. In other words, we believe that a Tobin tax—named after a proposal by Nobel laureate James Tobin—while welcome, would be insufficient to reduce the recent instability of financial markets. In our view, there is a place for a wide range of quantitative controls. For example, governments can impose restrictions on external borrowing by domestic firms, on both bank credit and bond issues. Also, amounts of

cash sent abroad by multinational firms and by domestic citizens could be limited.

The following section of this article explores the debate on exchange rate regimes and shows that the underlying differences depend crucially on policy objectives. It is argued that exchange rate regimes are of secondary importance, since it is possible to pursue either full-employment or price stability policies irrespective of the exchange regime in place. The succeeding section deals with the crucial issue of capital controls. It will be shown that full-employment policies do require the imposition of capital controls.

The False Dichotomy

Over many recent decades, both Keynesians and monetarists have generally at one time or another favored both fixed and flexible exchange rate regimes. Therefore, to assume that Keynesians necessarily favor fixed regimes whereas monetarists prefer flexible regimes is wrong. Far from being a flagrant contradiction, both camps' theoretical defense of each regime was recognition of their use in defending an overall macroeconomic policy objective. One thing is certain: When Keynesians support flexible regimes, monetarists will overwhelmingly support fixed parity, and vice versa. The reason is that their regime policies depend on their respective macroeconomic policy objectives, which are typically in conflict.

John Maynard Keynes himself is a good example of this switch in exchange rate position. In the 1920s, when unemployment was the crucial problem facing the British economy, Keynes defended a return to gold but at a devalued parity. Once the British economy returned to gold at the prewar parity—which Keynes considered overvalued—Keynes became a staunch defender of floating the British pound (Keynes 1963 [1925]). He

famously attacked Winston Churchill, then the Chancellor of the Exchequer, for the return to the gold standard. Keynes's logic was that a fixed exchange rate regime, in the absence of capital controls, led to a high interest (bank) rate. Since this result would undoubtedly depress aggregate demand and the whole economy, creating unemployment in the process, he resisted the fixed parity system. When Britain was forced out of the gold standard, Keynes was undoubtedly happy. He argued that "there are few Englishmen who do not rejoice at the breaking of our gold fetters" (1963 [1931], 288). The pound crisis of September 1931 was for Keynes a vindication of his criticisms of government policy since 1925.

In the 1940s, on the other hand, Keynes resolutely defended the fixed but adjustable parity system proposed at Bretton Woods (1971; Crotty 1983). The logic was just as evident: The institutional circumstances had changed dramatically, now putting in doubt the use of flexible exchange rates in achieving full employment. The reconstruction of the postwar order was being designed, and a fixed parity regime would be necessary in order to attain macroeconomic stability.

Keynes's main concern was not related to the exchange rate regime but to the more pressing problem of unemployment. If fixed parities, with the aid of strict capital controls, allow for low rates of interest, then fixed parities are seen as beneficial since they will encourage employment growth. It must be noted that fixed parities are crucial because they also reduce the possibility of speculation and thus help to curb short-term capital flows.

The same apparent ambiguity might be noted in the case of Keynesian authors. The term "Keynesians" is used loosely here, but it is mainly associated with Left Keynesians or post-Keynesian authors. Paul Davidson (1991), for example, is a defender of fixed exchange rate regimes. John Smithin (1996) and Thomas Palley (1998), on the other hand, argue in favor of floating exchange rates.

This same shift occurred in the mainstream or monetarist school, where economists were committed to fixed parities during both the gold standard and interwar periods but supported flexible exchange rates during the Bretton Woods period. In the late 1980s, a new shift occurred in the monetarist view, reverting to a defense of fixed rates. In the monetarist case, however, support for respective regimes is linked specifically to their ability to encourage price stability. If a flexible exchange rate is considered the best way to avoid foreign inflationary pressures—caused by foreign central banks committed to full employment policies rather than price stability—then flexible rates are defended. In fact, this was the basic argument put forth by Milton Friedman (1953), and it also served as the main theoretical criticism of the Bretton Woods system.

The monetarists' defense of flexible versus fixed parity can be explained by their interpretation of the collapse of Bretton Woods. Monetarists argue that the increasingly expansionary fiscal policies of the 1960s—resulting both from the Vietnam War and the Great Society experiment of the Johnson administration—were responsible for the growing balance-of-payments deficits, since these policies were inflationary and reduced the attractiveness of U.S. goods. Monetarists did recognize, however, that U.S. deficits were initially instrumental in the working of the international monetary system, which was desperately in need of dollars to obtain the imports of capital goods essential for war reconstruction. By the late 1960s, U.S. deficits were doing more harm than good, since the accumulation of idle dollar balances led to mounting pressure on the money supply of the rest of world, thereby leading to inflation.

According to monetarists, the exogenous increase in the money supply in the United States caused inflation in this country. Further, if foreign countries failed to buy dollars and increase their respective money supplies, then their currencies would appre-

ciate. Yet, under the fixed parity conditions of the Bretton Woods system, currencies were not allowed to appreciate. The fixed parity system was the mechanism by which inflation spread around the world. That is, according to the Friedmanian logic, inflation was caused by U.S. fiscal and monetary policies and was transmitted to the rest of the world as a result of the system of fixed parities. Flexible exchange rates thus would allow fiscally responsible governments to avoid inflation.

Contemporary discussion of mainstream macroeconomic theory and policy has been dominated by the current concern with fiscal restraint and monetary stability (Pivetti 1993, 103). With respect to exchange rate regimes, this debate has been translated into the consensual view that fixed exchange rate systems create environments that are more prone to produce fiscal discipline and low inflation. The modern version of monetarism argues that if foreign central banks were committed to price stability, then a worldwide concerted assault on inflation would be successful. In this sense, fixing the exchange rate might be a good strategy for fighting inflation. This is the basic argument of Franco Giavazzi and Marco Pagano (1988) and the main theoretical argument in favor of the European Monetary Union and of the exchange rate-based stabilization policies in Latin America.

Monetarists have also defended the use of currency boards and direct dollarization, that is, the abandonment of domestic currencies, for the same reason. For them, currency boards can replace irresponsible central banks that follow monetary policies conducive to inflation (Barro 1998).

Capital Controls and Progressive Economic Policy

In our view, the fact that many economists swapped their positions in the fixed versus flexible exchange rate regime indicates that there is no a priori advantage in one exchange rate regime

over the other. However, there is a less noted but more important policy dichotomy that clearly divides those concerned with price stability and those who give priority to full employment policies. As shown in the literature, authors concerned with price stability are, without exception, in favor of free mobility of capital, and the opposite is true of those concerned with unemployment. This dichotomy can be readily explained by economic theory.

Neoclassical economics essentially argues that, left to itself, the economic system will tend to allocate resources efficiently. As a result, unemployment can result only from some type of market imperfection and should not be a major policy concern. If high rates of unemployment do exist, as in Europe, what is needed is deregulation in order to make the labor market more flexible. Labor and capital, the so-called factors of production, should move freely so that market forces will provide the optimal outcomes. As John Eatwell has correctly pointed out (1996, 8), the main defense, albeit not the only one, of the liberalization and deregulation of capital markets relies on the belief that a free capital market will allocate resources efficiently—the so-called Efficient Market Hypothesis.¹ However, the notion that financial markets are efficient contrasts with the deterioration of economic performance in the post-Bretton Woods era, a period characterized by slow productivity growth and free capital mobility.

According to the Keynesian view, the absence of capital controls imposes deflationary pressures on the system. The relationship is quite simple. Steady outflows of capital, caused by a number of variables such as uncertainty and speculative behavior, tend to devalue the national currency. If one of the objectives of the central bank is to stabilize the currency, it will raise the rate of interest and attempt to cushion the fall of the exchange rate. High or rising rates of interest will have a negative influence on effective demand and depress the economy.

Monetarists argue that the central bank controls the money supply. Conversely, Keynesians argue that the main policy variable is the rate of interest. According to Nicholas Kaldor (1985), the rate of interest is determined exogenously by the monetary authority (Rochon 1999). As acknowledged by Alan Blinder, "the central bank controls the short term nominal interest rate" (1997, 38). The decision to raise the rate of interest must therefore be interpreted as a policy decision favoring a defense of the national currency over policies of full employment.

In contrast with the monetarist view, the relatively poor performance of the advanced capitalist economies since the demise of Bretton Woods is explained by some economists as a shift of power from labor to finance (Greider 1987; Smithin 1996). Jagdish Bhagwati (1998) refers to the rising of a Wall Street–Treasury complex that replaced the military–defense complex of the Eisenhower era. This can be briefly summarized as follows. Deregulation and liberalization of capital markets created a tendency for higher rates of interest, since once capital flows cross freely from one country to the other in search of higher returns, central banks that are not willing to allow their countries' currency to depreciate—that is, do not want capital flight—will have to increase the attractiveness of their currency by bidding interest rates up. The increase in the rate of interest, in turn, increases the burden of government debt by increasing the financial component of the fiscal deficit.

In order to be able to control interest rates for domestic purposes, restrictions on the free mobility of capital are essential. Otherwise the negative effects these movements in capital will have on interest rates, and hence the economy, can be devastating. We will return to this point.

One can find some support for this view in Keynes's writings, where he argued emphatically that "we cannot hope to control rates of interest at home if movements of capital moneys out of

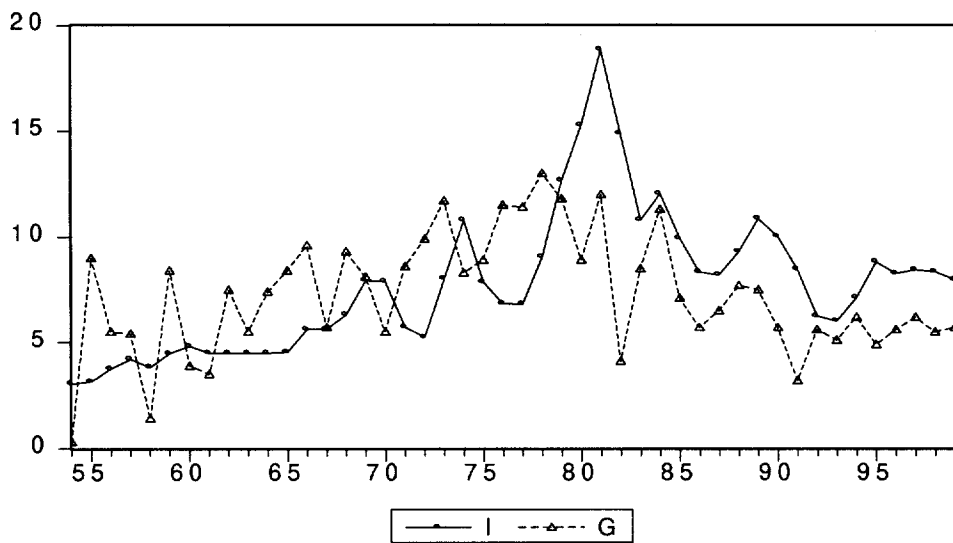


Figure 1. Relationship Between Interest Rates and Growth Rates

the country are unrestricted" (1971, 276). Keynes saw capital controls as an essential policy instrument in developing aggregate demand, full-employment policies. Once such a regime is adopted, a country can expect to maintain control over its monetary policy. If full employment is a desirable goal, then a policy of low real rates of interest ought to be followed. In the *General Theory*, Keynes favored such a policy since it would lead to what he called the "euthanasia of the rentier" (1964 [1936], 376). Keeping interest rates low would also allow for the "socialization of investment" and full employment (*ibid.*, 378; Lavoie and Seccareccia 1988).²

Notwithstanding the conservative revolution of the 1980s, the post-World War II prosperity can be seen as a vindication of Keynes's proposals.³ Advanced capitalist societies experienced the highest rates of growth in history (Glyn et al. 1990), and the period from the end of the war until the breakdown of Bretton Woods became known as the golden age of capitalism. One of the crucial characteristics of that period, as can be easily seen in Figure 1, is that the rate of interest was always below the rate of

growth of the American economy. This pattern is reversed in the post-Bretton Woods era, in particular after the tight monetary policies of Paul Volcker in the late 1970s.

One of the effects of higher rates of interest and lower rates of growth is the increase in the fiscal burden of debts. Several well-known theorems of debt dynamics show that debt-to-GDP ratios tend to increase at explosive rates when the rate of interest exceeds the rate of growth. This consequence can be easily understood in the following way. The rate of interest on government bonds is the rate at which treasury debt increases, while the rate of growth of the economy is a *proxy* of the capacity to pay for the debt, since revenues rise in a booming economy. Consequently, if the rate of interest is higher than the rate of growth, then the burden of debt is rising faster than the ability to pay, and the proportion of debt to GDP must rise (Galbraith and Darity 1995). The main consequence of this proposition is that fiscal deficits do no harm—on the contrary, by increasing spending, they tend to increase income and employment—provided the rate of interest is lower than the rate of growth of the economy (see box).

Dividing the postwar era into these two separate periods, 1950–80 and 1981–98, is a good way of seeing the dramatic change in the relative impact of interest payments on fiscal policy. In Figure 2, we can see that government federal interest payments (GFIP) as a proportion of government federal expenditures (GFEXP) in the United States increased considerably from 1980 to 1999, approximately doubling from an average of 7 percent of total spending to more than 14 percent. Also, the ratio of increased interest payments to GDP also increased dramatically over this same period, going from slightly more than 1 percent to more than 3 percent. The conventional explanation for these stylized facts has been typically associated with the Reagan tax cuts. According to this view, the tax cuts, supplemented by expansion-

DEBT-GDP STABILITY

A simple way to assess the burden of debt is to study the debt-servicing requirement vis-à-vis the capacity to service the debt. A typical measure is the debt-to-GDP ratio. Let's define the debt-to-GDP ratio as

$$d = D/Y \quad (1)$$

where D is the inherited stock of debt, and Y is the flow of income, that is, the gross domestic product. It is quite obvious that the rate of growth of d is the difference between the rate of growth of D minus the rate of growth of Y . That is:

$$\frac{\dot{d}}{d} = \frac{\dot{D}}{D} - \frac{\dot{Y}}{Y} \quad (2)$$

Further, the change in the stock of debt is equal to the budget deficit plus interest payments on government debt. Formally:

$$\dot{D} = (G - T) + iD \quad (3)$$

where G is government spending, T is the tax revenue, and i is the rate of interest. Substituting (3) into (2), and renaming the rate of growth of income as g , we get

$$\frac{\dot{d}}{d} = (i - g) + \frac{(G - T)}{D} \quad (4)$$

In conclusion, the rate of growth of the debt-to-GDP ratio is the sum of the difference of the rate of interest and the rate of growth, and the ratio of the budget deficit to the stock of debt. It is easy to see that even for a positive but constant public deficit, the debt-to-GDP ratio will be falling in time if the rate of growth exceeds the rate of interest.

ary defense spending, led to higher deficits, which in turn resulted in higher rates of interest (Friedman 1988).

In our view, causality runs the other way round. Higher rates of interest came first, still during the Carter administration, as a result of the rise in the federal funds rate during the Volcker tenure as chairman of the Fed. This had an impact on interest payments and hence on the deficit, which was intensified by the tax cuts in the Reagan administration. In that sense, the main

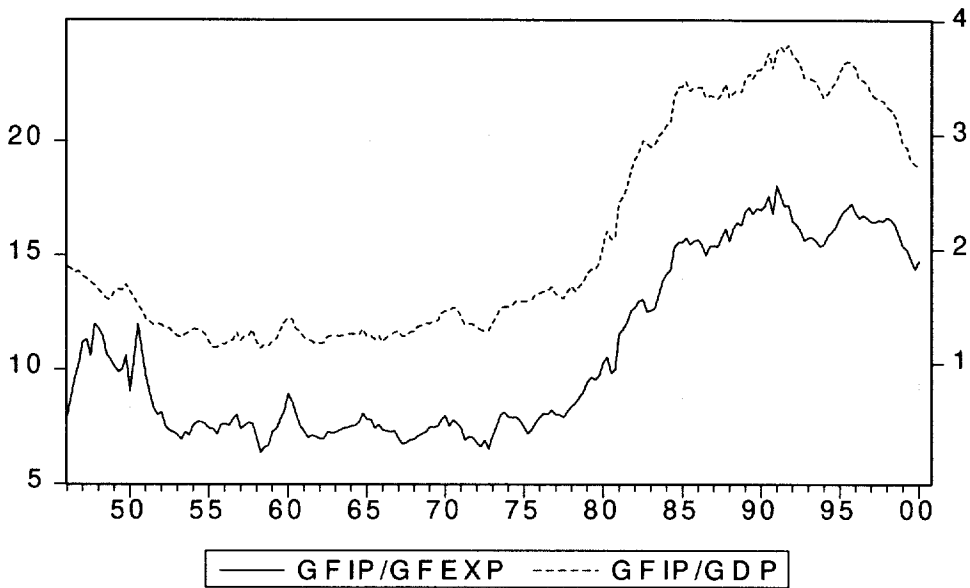


Figure 2. Relationship Between Interest Payments and Expenditures

consequence of the Reagan tax cuts lies in income distribution rather than in the rates of interest (Wolf 1996).

Also, the importance of interest payments in overall federal government expenditures was an issue following the war, as Figure 2 shows. Indeed, in 1950, the ratio is only somewhat smaller than those of today and of the recent past. But that outcome only strengthens our point. World War II was a costly undertaking, but its financing (or burden) in the following years was made manageable precisely because of the lower rates of interest compared to growth. The ratio steadily declined over the years, until it became an issue once more. But now, the context is different: The rate of interest is greater than the rate of growth.

The increase in interest payments intensified the pressures for cutting expenses in social programs, as much as the previous era of low interest costs stimulated social spending. Not surprisingly, many of the welfare state programs in the United States as well as in Western European countries were developed in the Bretton Woods era—for example, Medicare and Medicaid in the

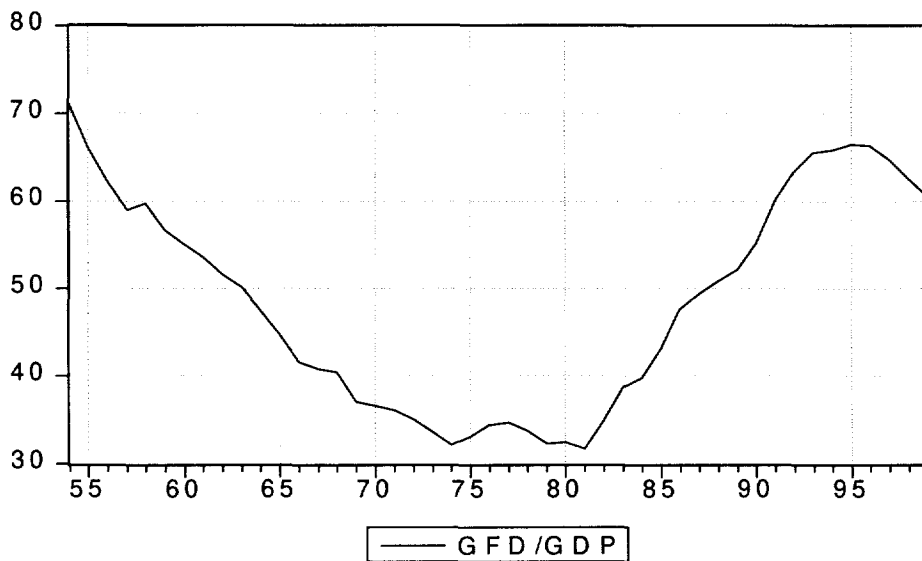


Figure 3. Relationship Between Gross Federal Debt and GDP

United States during the Johnson administration. In other words, when rates of interest were low compared to growth rates, welfare state programs could be pursued without increasing the burden of debt. The reverse happened in the last twenty-five years, when the rates of growth were lower than interest rates, that is, when social programs were partially or completely scrapped.

In addition, as it can be seen in Figure 3, the rise in interest rates led to a soaring in the federal government debt. The gross federal debt (GFD) to GDP ratio, which fell steadily during the golden age from the high level of 70 percent after World War II and the Korean War to the low level of 30 percent in the mid-1970s, is now back to its 1950s level.

In the present context, where balanced budgets are welcomed, increased interest payments logically imply decreased fiscal spending in other areas. To pay the increasing burden of the debt, we must sacrifice other areas of the economy. The so-called increased burden of the debt is, to a considerable extent, the direct result of a deliberate policy of maintaining high rates of interest. Those rates of interest, in turn, are directly associ-

ated with the free market policies of deregulation and liberalization of capital markets, as explained above. The pursuit of a progressive agenda of higher social spending must necessarily deal with the reduction of interest rates, which seems to be intrinsically related to financial regimes, that is, whether or not capital controls exist.

Concluding Remarks

Any discussion of exchange rate policies must be clearly embedded in an understanding of the different policy priorities of different economic schools. Fixed-versus-flexible-regime discussions are less relevant than discussions on whether there is a need to reintroduce capital controls and on the desirability of price stability or full employment. It seems that a thorough understanding of the recent development of the capitalist system demands an analysis of the causes that led to the regime change of the 1970s, when an overwhelming priority of reducing inflation took over all other objectives of macroeconomic policy. This regime change is clearly connected to the political decision to lift capital controls.

The main objective of capital controls was, as we argued, to minimize the cost of government debt service. Free capital mobility forces monetary authorities to bid up rates of interest to attract capital flows and results in higher interest payments. Hence, with capital controls, fiscal policy was free to pursue the socially desirable objective of full employment. The side effect of this institutional arrangement was the maintenance of low rates of remuneration for financial assets. The obvious implication is that the reimposition of capital controls will, to a certain extent, hurt financial capital interests.

Two arguments have been put forward against capital controls. Some economists argue that capital controls frighten in-

vestors. Others claim that the discussion on capital controls is irrelevant since they are not feasible, given the fact that regulations are ultimately avoided by financial innovations (Goodhart 1995). Three counterarguments must be noted in this context.

First, we do not favor limitations on capital flows for trade or long-term investment. The main target of capital controls ought to be portfolio flows. In particular, in the case of developing countries that are dependent on capital imports, foreign exchange controls might be important in order that the productive process not be disrupted. That is, only regulations that help production and employment should be considered.

Second, the fact that capital controls are difficult to implement does not preclude the discussion of their relevance. In the same way that banks and other financial institutions try to create new instruments that circumvent restrictions, central banks can design new regulations and regulatory frameworks. For example, John Eatwell and Lance Taylor (2000, 219) argue that the effective regulation of the international financial system demands a world financial authority (WFA). Since financial institutions are global players, the regulatory organism has to be a global player also. A WFA would allow information gathering across borders and would increase the effectiveness of capital controls. In fact, we believe that the only way capital controls can be effective in a world of constant financial innovation is to create a new flexible framework for regulating financial markets.

Third, and more important for those who believe that governments have lost their capacity to regulate an increasingly globalized market, one should remember Eric Hobsbawm's penetrating insight:

We must distinguish between what states cannot do, on the one hand, and what they could do if they wanted to. Much of what governments refrain from doing is rejected not because it is ineffective—for instance,

economic protectionism and a degree of self-sufficiency can work—but because, for various reasons, governments do not desire it. (1996, 274)

The same could be said about capital controls. The question to be asked, then, is whether the shift of power in favor of financial interests is the inevitable outcome of the development of capitalism, the so-called globalization process, or simply the result of the dominance of particular interests within the state structure.

Notes

1. It is important to note that there has been a renewed interest within mainstream economics in the imposition of capital controls. The so-called Tobin tax (Tobin 1978) has been an important issue of discussion among mainstream economic circles. However, as correctly noted by Paul Davidson (1997), a Tobin tax is an improbable candidate to solve the problems brought on by short-term capital movements.

2. Richard Cooper (1999) defends similar views.

3. This is not to say that there are no other important elements in the explanation of the postwar boom. The Marshall Plan, the cold war, and the worldwide expansion of the Fordist mass production system are all important elements of the Bretton Woods period.

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