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Problems and Policy

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Economics is ultimately about policy. Though we inevitably spend most of our time and effort in trying to understand the causal processes at work, this is because if we do not know what *is*, we cannot say what *should be*. The previous chapters have offered an explanation of the former. The core conclusion is that currency markets are dominated by short-term capital flows, which are in turn driven largely by psychology as guided by agents' mental model. As a consequence, the international economy may be marked by, among other things, large, chronic trade imbalances, exchange-rate volatility, and bandwagon effects. The imbalances occur because one price cannot, except by coincidence, clear two markets at once; the latter two are not only problems in and of themselves, but they contribute to currency crises which, particularly in developing nations, may cause considerable harm to a macroeconomy. Exchange rates do not automatically adjust to make our lives more pleasant.

What should be done? In general, Post Keynesians pursue policies that generate high levels of output and employment. Price and financial market stability are also desirable, largely because they are assumed to contribute to the ends previously mentioned. The international monetary

system as currently designed frustrates these goals in a number of ways:

1. currency prices are mis-determined because they are driven by short-term time horizons instead of long;[1]
2. currency price volatility reduces the expectation of profit from investment and, therefore, the level of aggregate demand;
3. currency price mis-determination and volatility reduce the level of world trade;
4. currency markets contribute to developing countries' woes; and,
5. the manner in which the international monetary system operates tends to create contraction and unemployment.

Each of these will be addressed in turn, after which measures that can avoid them will be outlined. Note that there will be overlap among these descriptions, particularly since all are related in one way or another to financial capital markets.

CURRENCY MARKET PROBLEMS

Throughout all that follows, it is important to remember how closely currency and asset markets are related in the real world. As explained in chapter three, there is no more important factor in foreign exchange rate determination than the flow of portfolio capital. When agents expect a currency to appreciate, they buy assets denominated in that currency; and when a particular country's assets become more popular, so the money in which they are denominated will appreciate.

Inappropriate Time Horizons and Mis-determined Exchange Rates

In chapter twelve of the *General Theory*, Keynes starts by examining the decision to undertake physical investment and then shifts almost imperceptibly into a discussion of the stock market. He does so on the assumption that, "...the daily revaluations of the Stock Exchange, though they are primarily made to facilitate transfers of old investments between one individual and another, *inevitably exert a decisive influence on the rate of current investment*" (emphasis added; Keynes 1964: 151). This is so, he says, because, "...there is no sense in building up a new enterprise at a cost greater than that at which a similar existing enterprise can be purchased" (Keynes 1964: 151). If the stock prices of firms that make furniture are declining, those considering building or expanding such a company will take this as a negative sign. Thus, stock market valuations directly impact on the expected rate of profit from investment variable (p^e).[2] This is shown in equation 5.5:

$$I = (r_{us}, p^e). \qquad 5.5$$
$$\quad\; - \;\; +$$

One of Keynes' central concerns in this regard was that the influence of asset markets on physical investment would tend to shift the time horizon used to make such decisions. Physical investment is a long-term phenomenon. The consequences of building a factory, restaurant, retail shop, etcetera, extend well into the future, beyond, in fact, the range over which one might have a chance of generating a reasonable forecast. Still, a forecast must be made if a decision is to be rendered. In doing so, a number of weighty factors must be considered, among them being one's managerial and marketing skills, consumer tastes, technology, competition, government

regulations, and so on. The investor must study not only the current states of these variables, but possible future ones, as well as those affecting all potential competitors. These deliberations are terribly important because once the physical investment process is underway, there is no realistic means of reversing it. Changing your mind once underway will almost certainly mean lost money, perhaps substantial amounts thereof. You cannot decide overnight to no longer be a restauranteur without incurring significant costs and so it is therefore illogical to constantly reevaluate the profitability of your restaurant when the physical capital invested cannot be magically changed into a shoe shop. Consequently, agents can be expected to take this very seriously and they will expend a considerable amount of effort at the forecasting stage. In terms of economic outcomes, this is as it should be. The investment decision, for the individual and the community, will be better done if agents spend time and effort considering it.

In the stock market, however, one can divest oneself of an asset in moments. There is little need to undertake the burdensome task of doing the careful research mentioned above because the average cost of an error is so much lower. In such circumstances, market participants find that their energies are more profitably spent forecasting the psychology of the market–what Keynes called “speculation” (Keynes 1964: 158). The rest of the market, too, will likely have a very short time horizon since agents have no strong connection to the asset in question. Thus, speculative forecasts rarely look very far into the future.

This has an inevitable effect on new physical investment. The short-run mentality creates (in combination with the heuristics mentioned in chapter three) a tendency to overreact to

information. Just because, for example, there has been a rise in the price of raw chicken should not necessarily mean that there will be a large impact on the long-run profitability of a restaurant chain that specializes in poultry dishes. Everything else being equal, they may well be able to make adjustments (including shifting to another speciality) that allow them to keep profits at or near current levels. They frankly do not have a choice–as mentioned above, they cannot suddenly change their restaurant into a shoe store. Since they cannot now choose whether or not they run a restaurant, they accept the new market conditions and start working on a solution. But, those dealing in secondary sales of the company's stock may well take the rise in costs as a sign to begin an exit. Their primary concern is what other asset-market participants will think, not how the management team will adapt. In fact, the low cost of divesting themselves of assets means that they and their colleagues probably knew relatively little about restauranteering in the first place. Thus, their ignorance will contribute to their decision. "Surely," they will think, "a rise in the cost of raw chicken is a bad thing–sell!"

This may have direct effects on the company itself. First of all, the stockholders are the true owners of the firm. If the falling stock price is seen as an indication of bad management, then managers may be replaced. Alternatively, there could be a buy out of the enterprise in question. Financial institutions may perceive the falling stock price as a negative, making loans more expensive and thus frustrating management's attempts to address the underlying issue. In any event, the firm's managers may be forced into plans of action that raise the short-run stock price rather than solve the long-run problem. These two courses may not always be incompatible, but when they are the incentive will be the select the former. In summary, the short-run orientation of

financial investment is imparted to physical capital formation, with the consequence being that those conducting the latter may find themselves in a situation where they must spend more time and effort satisfying stock owners than truly solving problems.

Returning to currency markets, the fact that they are so closely tied to financial capital means that forecasts there, too, have an unreasonably short time horizon and are hence "mis-determined." National currencies should logically reflect the relative value of the goods and services produced in that country (as related to the current account) and the profitability of firms based there (as related to the capital account). These are the ultimate reasons for holding the money issued by a particular state and if markets were driven only by these then we would witness currency-market participants thinking long and hard about committing to a particular foreign currency and changing their minds only when considerable evidence had accumulated to convince them that their earlier, well-considered opinions were wrong. But, instead, it is Keynes' game of musical chairs on a global scale. This cannot be proved directly, but look back at the figures in chapter six showing the movement of the dollar since the collapse of Bretton Woods. Is it really possible to justify the massive swings we have witnessed in terms of some set of fundamental factors related to relative appeal of US goods and services or the profitability of US enterprises? Even Neoclassical economists doubt this; Post Keynesians simply reject it.

None of this would be terribly relevant if currency prices had little connection to real economic activity. But exchange rates are terribly important signals in the allocation of physical and financial resources. It has been argued even by those in the Neoclassical camp that currency price

speculation can have consequences that are “devastating for particular sectors and whole economies” (Eichengreen, Tobin, and Wyplosz 1995: 164). This is particularly so for small, developing economies where the underlying base is fragile at best. As described at the end of chapter six, currency crises, caused in part by these short-term biases, can lead to social disasters for those least equipped to deal with them. Even the day in, day out movement of currency prices in a system like ours is suspect. Mis-determined exchange rates lead to a misallocation of resources because they are not sending the appropriate signals to those involved in the activities that create output and employment. Government policy makers, too, often find themselves implementing policies that are designed to please the portfolio investors who are driving the currency market rather than solving economic problems.

Currency Price Volatility and the Expectation of Profit from Investment

Not only does the undue influence of asset markets mean that currency prices are mis-determined, but they are also volatile. As explained in chapter three, volatility is a direct function of uncertainty, availability, representativeness, anchoring, the desire for quick results, animal spirits, and convention. Their effect is greatly magnified by the short time horizon of portfolio investment. Hence, forecasts are subject to very frequent revision, and along with them the portfolios of agents (which then drives currency prices).

What this means for output and employment is that rapidly fluctuating currency prices add to the environment of uncertainty within which entrepreneurs must already operate. Such an effect might

not only increase liquidity preference and thus reduce spending and raise the cost of cash, but it may also directly reduce the expected rate of profit from investment. As Keynes argues in chapter twelve of the *General Theory*, in the absence of our innate tendency to action rather than inaction, very little physical investment would take place (Keynes 1964: 161). A volatile currency market simply adds one more, unfortunately rather prominent, variable to the list of those with the potential to upset "the delicate balance of spontaneous optimism" (Keynes 1964: 162).

Currency Price Volatility, Mis-Determination, and World Trade

It is easy to imagine that the conditions described above would be particularly discouraging to those entrepreneurs in the import/export sector. For them, a rapidly changing currency price is not just a symbol of uncertainty, it is a direct and significant influence on their profits. Beyond the short-term volatility, the sort of long swings we have witnessed in currency prices since the fall of Bretton Woods would also have a deep impact on firms' viability. Smaller firms would be the hardest hit, leaving us with a less competitive world economy, which has negative repercussions for income distribution and aggregate demand.

Currency Markets and the Developing World

Everything said above applies to both the developed and developing world; however, the consequences in the latter tend to be more serious. Keynes' "delicate balance of spontaneous optimism" is especially tenuous in the third world and even the milder volatility and price swings

we see in developed economies would be sufficient to destabilize them; instead, they tend to be much greater. Furthermore, the very threat of events like those that occurred in Mexico and Thailand may be sufficient to discourage those wishing to undertake economic activity. At the very least, the sort of investment that takes place will be affected, with the likely result that real will suffer relative to financial (and the Mexican and Thai data in chapter six indicated). The myriad other problems faced by developing states who decide to open their stock markets to international investors has been amply covered by Ilene Grabel and will not be discussed here (see, for example, Grabel 1999). Suffice it to say that the current structure of the international monetary system tends not to encourage economic development and the default "solution" of liberalizing portfolio capital markets has not only served to make matters worse, it has meant that other programs have not been pursued instead.

Currency Prices, Trade Flows, and Contractionary Tendencies

The last problem created by the current structure of the international monetary system is again related to the dominant role of financial capital, but not as directly. Recall from chapter four that a flexible exchange rate system can be in equilibrium even if there are trade imbalances. This is in contrast to Neoclassicism's view which argues that, at least over the long run, exchange rates act as an equilibrating mechanism for less-competitive countries and thereby create balanced trade. Hence, nations faced with a potential drain on economic activity–i.e., a trade deficit–can rest assured that currency prices will soon move to correct this problem. Foreign exchange rates thus play for them a role analogous to interest rates in keeping injections and leakages at the level that

guarantees full employment.

Their view is premised on the idea that capital flows are very small and arising primarily as a means of financing trade imbalances. In reality, however, the overwhelming majority of currency transactions are related to autonomous short-term capital flows. Even when large trade deficits create significant problems for a macroeconomy, it is more common that they be offered new financing options than be forced to reduce imports to the level of exports (Shaikh 1980 and 1996 and Shaik and Antonopoulos 1998). In short, our exchange rate system does not operate so as to automatically correct trade imbalances (the subject of chapter four); that this is true is due to the role played by capital flows.

This is not a new theme in Post Keynesian exchange rate literature. Keynes (1980) argued this, and Davidson has continued to do so: “Keynes...recognized that large, unfettered capital flows could create serious international payments problems for nations whose current accounts could otherwise be roughly in balance” (Davidson 2002: 481). Though it is likely that, as the balance-of-payments-growth constraint theorists have argued, non-price variables play a significant role in driving trade flows so that exchange rate movements might not be sufficient to completely eliminate imbalances, it would nevertheless be preferable to observe that the currencies of trade deficit nations depreciated while those of surplus countries appreciated.

The above is not so much an explanation of how exchange rates create a problem as how they do not automatically solve one. There is a systemic issue, however, and it is as follows. While it is

true that nations with trade deficits can carry them indefinitely, ceteris paribus, they would rather not. It is a drain on employment and financial resources. And since currency prices, for the variety of reasons mentioned above, have no built-in tendency to correct the problem, often the only option available to concerned policy makers is a reduction in the overall level of domestic economic activity. This is an effective means of addressing the issue (consider the effect of a fall in Py given a relatively flat BTFX in the open-economy Z-D diagram), but one that causes a contraction in the level of economic activity both at home and abroad. The likelihood of this scenario emerging is much greater when the organization of an international payments system, in spite of the fact that it is much less painful for those with a surplus to spend more than those with a deficit to spend less, places the burden of adjustment on the deficit country (Davidson 1992-3 and 1999). And, as shown in chapter four, the larger are the autonomous capital flows, the larger can be trade imbalances. Thus, the operation of our exchange rate system introduces to policy a contractionary bias as those with trade deficits may have an incentive to shrink their economies. As their imports fall, so the deflation is passed on to their trading partners–who may respond in kind.

POLICY

The current structure of the international monetary system causes currency prices to be mis-determined and volatile, reducing the expectation of profit from investment and the volume of world trade. This contributes to developing countries' problems and imparts a contractionary bias to economies throughout the world. Solving this requires, first and foremost, a significant

reduction in the volume of international financial capital flows. Surely the evidence of the past thirty-plus years is sufficient to bury the orthodox fetish of liquidity once and for all. It is high time to admit that it is simply not true that allowing free flows of portfolio capital, alone, somehow encourages economic growth and development. Instead, what we get is distortion and volatility. To quote Keynes only slightly out of context, the conditions necessary for the Neoclassical story to be true "happen not to be those of the economic society which we actually live, with the result that its teaching is misleading and disastrous if we attempt to apply it to the facts of experience" (Keynes 1964: 3).

The limitation of portfolio capital flows can be accomplished in a variety of ways, as outlined below. That is the central recommendation of this volume. In addition, Paul Davidson's suggestions with respect to reform of the international monetary system are relevant here and will be reviewed. Last, a few words are said on the issue of fixed versus flexible exchange rates.

Capital Controls

The core of any successful international monetary reform lies in the implementation of capital controls. *The ultimate goal of these would be to eliminate mis-determination and volatility by forcing market participants to take more care in the research undertaken prior to the physical or financial investment decision and to feel a stronger bond to the asset once purchased.* Note that setting out to change those interested in quick profits into long-term investors is not likely to be a realistic ambition. Rather, we simply want to discourage those in the former group as much as

possible, without adversely affecting the participation of those in the latter.[3]

A tax on exchange rate transactions is often proposed as a remedy. The fact that one of the proponents for this idea (sometimes called a “Tobin Tax”) comes from the Neoclassical camp is an indicator of the severity of the problem discussed here (Tobin 1978). The basic idea is that a levy in the range of .1 to 1% be placed on all exchange rate transactions, thus discouraging those made only in pursuit of capital gain while, at the same time, generating funds for use in economic development. Unfortunately, such a small cost is very unlikely to have an impact when typical exchange rate swings are more than sufficient to generate speculative profits (or the hope thereof) well in excess of that amount (Davidson 1997). Furthermore, taxes high enough to have a substantial effect on portfolio capital flows would probably serve as an even greater deterrent to long-term investment. This is not to say that a Tobin tax or something similar might not play some useful role, but by itself it would be rather feeble and would not be applied with the selectivity necessary to achieve the main goal.

What would be preferable is something similar to the program Chile employed from 1991 to 1998 (Neeley 1999: 25). Although its characteristics changed over time, the central features were a requirement to keep funds in Chile for a prescribed period, a compensating mandatory deposit with the central bank (non-interest paying), and a penalty for early withdrawal. Each of these was more stringent for portfolio capital flows than direct and thus properly discriminated between the two sets of investors. Whether these were effective or not depends on who you read. Ilene Grabel, a Post Keynesian, is a supporter and argues that such a system could effectively prevent

the outbreak of a financial crisis, mitigate the effects if one occured, and limit contagion (Grabel 2003–this is an outstanding article that I highly recommend). While the reactions of Neoclassical authors are mixed, some actually align themselves with Grabel and there appears to be agreement even among detractors that the composition of capital flows shifted away from the short and toward the long term (Neeley 1999). This is precisely the goal. It is instructive to observe that Chile suffered no fallout from the Mexican crisis in 1994 or the Asian in 1997. The measures have now been dismantled, however, leading Grabel to comment:

> In my view, the decision to terminate inflow management was imprudent given the substantial risks of unregulated short-term inflows and the risk that Chile could be destabilised by emergent crises in Argentina and Brazil. It would have been far more desirable to maintain the controls at a low level, while addressing the current account deficit and the need to attract inflows through other means. Indeed, flexible deployment of the inflows policy was a hallmark of the Chilean model (consistent with trip wires– speed bumps), and it is regrettable that authorities abandoned this course.
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> (Grabel 2003: 327)

I strongly agree both in terms of the need to control the short-term flows and in the necessity of governments maintaining flexibility in this regard. It is all but certain that not only will market conditions change, but investors will seek ways around regulations. Thus, we cannot expect to simply put policy in place and sit back. Ensuring that all clearing must take place through the

central bank would be helpful in this regard. This would greatly enhance the power that each nation would have “to monitor and, if desired, to control movements of flight capital” (Davidson 1992-3: 158).

The strength and precise nature of the regulations implemented is a question that can only be answered on a case-by-case basis. In general, developing states will require greater efforts to limit financial capital flows, along with closer supervision and larger imposed costs. This is not to say that developed-country asset markets cannot create significant distortions and other problems, but when they do occur it is against a more stable backdrop than in the third world. Whatever exact limitations on financial capital flows are put into place, the policy makers involved must also create a system of trip wires and speed bumps to guide them (see Grabel 2003 for an extended description). The former give advanced warning of trouble. Assuming that business and government enterprises can be trusted to make transparent the important numbers in question, economists can monitor them for indicators of crisis like those mentioned at the end of chapter five and in the discussions of the Mexican and Asian incidents in chapter six. These would include debt-to-income ratios, relative levels of foreign debt, relative levels of short-term debt, and official foreign exchange reserves (all mentioned in the chapter five discussion of crisis). The signals generated do not guarantee that a problem is about to occur, but they serve as a heads up to policy makers that action may need to be taken. They should also act as a guide to longer-term policy adjustments. If, for example, it is found that domestic agents are taking on increasing levels of foreign debt, then regulations should be revised accordingly. A caveat here is that one must exercise care in reducing barriers to short-term capital on the assumption that low realized levels

of the latter indicate that it is no longer an issue–it may simply be that the regulations are doing their job and removing them may cause a resurgence!

With respect to speed bumps, these slow the rate of capital flows and thereby attempt to defuse a budding crisis. Grabel explains,

> Speed bumps can take many forms. Examples include measures that require borrowers to unwind positions involving locational or maturity mismatches, curb the pace of imports or foreign borrowing, limit the fluctuation or convertibility of the currency, or slow the exit and particularly the entry of portfolio investment. I emphasise the importance of speed bumps governing inflows rather than outflows because measures that merely target outflows are more apt to trigger and exacerbate panic than to prevent it.
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> (Grabel 2003: 323).

These may give policy makers time to formulate plans and might give cooler heads to prevail in the market.

One of the nice things about capital controls, trip wires, and speed bumps is that they may be employed unilaterally to great effect. It is not necessary for all nations to employ the same or even similar systems, though there would definitely be advantages to such an eventuality (particularly in terms of a general shift in the structure of world capital flows). But, as has been shown in Chile,

Colombia, Malaysia, South Korea, the United States, and so on, it is entirely possible for a single nation to find success putting into place rules that apply only within its borders (notwithstanding potential formal and informal sanctions from other Neoclassically-oriented nations and international "relief" organizations around the world). The goal of reducing the effect of exchange rate volatility and mis-determination can largely be solved one country at a time and the positive results can then be used to break down resistance elsewhere.

Burden of Adjustment Placed on Surplus Countries

The implementation of capital controls throughout the world would help to bring on what might be called the euthanasia of the speculator and get us most of the way to a monetary system that created a stable environment which supported output and employment growth. It would greatly reduce volatility and mis-determination, thereby increasing the expected rate of profit from investment and world trade. In addition, if portfolio capital flows were a smaller portion of total currency demand, we should expect to see smaller and shorter-lived trade imbalances. This would reduce the significance of the balance-of-payments growth constraint, make nations less likely to engage in deflationary policies to reduce imports, and lead to smoothly adjusting and more predictable exchange rates that should encourage agents to engage in output and employment creating activities across national borders.

Paul Davidson's writings have generally supported the above ideas, while adding extra measures. He has proposed an international monetary system based on an International Money Clearing

Unit, or IMCU (Davidson 1992-3, 1997, 1999, 2002, and 2003; Davidson credits Keynes with many of the central features). The IMCU would be held only by central banks, and would be used to settle accounts and act as the reserve asset. Each country would set an initial exchange rate of domestic currency units per IMCU, which would be fixed until the parties in question decide to change it. Unlike Bretton Woods, where it was incumbent on the deficit country to ask to have their currency devalued (which was politically unpalatable and something the surplus countries fought), here the burden is shifted to the surplus nation. Therein lies the key to the system and the solution to the problem of the bias toward contractionary policies. Once a surplus reaches a certain, prearranged level, the surplus country must either spend it (on imports or direct foreign investment into any other member of the clearing union, or as unilateral transfers to deficit members) or it will be confiscated and redistributed to debtor members. One way or another, this means that the funds accumulated by nations on the right of BTFX on the Post Keynesian open economy Z-D diagram (Figure 5.7) re-enter via upward D shifts for other members of the clearing union (in stark contrast to the downward D shifts in systems where the burden is on the deficit country). Only if a deficit country is rich and already at full employment are they forced to bear the burden of adjustment (via devaluation). Otherwise, the goal is to continue to inject money into the income stream and thereby keep the world economy expanding.[4]

The mechanism by which exchange rates would be adjusted is by relating them to efficiency wages, or the nominal wage divided by the average product of labor. As efficiency wages rise (due either to a rise in nominal wages or a fall in productivity), so a currency would lose value relative to the IMCU, and vice versa.[5] This not only creates another mechanism whereby trade

balances will tend toward zero (assuming labor productivity and wages to be the central factors in determining the international competitiveness of goods and services), but it insulates each nation from the others' inflation (Davidson 1992-3: 162-3).

Such a system, in combination with the goal of limiting portfolio capital flows, would create incentives to keep levels of economic activity high, channel funds to the most destitute, and allow individual nations to pursue more or less independent economic policies. Two mechanisms would operate to reduce imbalances: the linking of currency values to efficiency wages and the trigger mechanism whereby surplus nations are forced to spend. Exchange rates are more stable and no longer mis-determined, the limitation on capital flows eliminates the role of bandwagon effects, and the system no longer contains a deflationary bias. Hopefully, given such a fertile ground for growth, nations would also choose to pursue policies that achieve full employment–something with benefits that would multiply and spread to all the trading partners.

Fixed Versus Flexible Exchange Rates

The typical orthodox textbook discussion of exchange rate policy centers on whether we should have fixed or flexible rates. Generally speaking, the conclusion is that, despite the fact that within countries we use fixed systems within their borders, we should favor the latter. This is premised on the idea that flexible rates yield balanced trade and other efficiencies.

Though Davidson's system has fixed rates as one of its features, whether or not we let currencies

float is, in some respects, a secondary issue. While it is true that stable rates would avoid the problems associated with volatility, it is not necessarily true that having a fixed rate yields stability. In the absence of measures to limit portfolio capital, speculative attacks may force governments to continue to move pegs into ranges they can defend–thus creating the very volatility they had hoped to avoid. Davidson is well aware of this, of course, and his recommendations do include capital controls so as to make the fixed rates more manageable. Without that, his system (as he realizes) is untenable.

CONCLUSIONS

The current structure of the currency market is such that it allows short-term capital flows to dominate exchange rate determination. This, in turn, means that we experience chronic trade imbalances, misallocation of resources, depressed levels of economic activity, a contractionary bias to the international monetary system, and occasional catastrophic crises. What is recommended here is not a rejection of markets, but a modification. It is in that sense not a radical set of policies that is being advocated, and yet one would think so given the reactions of most economists and policy makers to the suggestion of capital controls. Particularly since the fall of communism and the rise of globalization, there seems to be an increasing willingness to trust in the logic of market solutions, particularly and ironically where they are most suspect: financial capital. While there are occasional waves of sentiment for reforms such as those recommended here (in the wake of the Asian crises or the US sub-prime loan debacle, for example), it appears that those in power and those who advise and elect them suffer from the same short memories as

Minsky’s representative agents.