EXCHANGE RATE REGIME PROPOSAL FOR EMERGING COUNTRIES: A KEYNESIAN PERSPECTIVE

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Abstract: This paper presents, in the light of Keynesian theory, an exchange rate regime proposal for emerging countries to assure macroeconomic stabilization, that is, price stability and full employment.

Key words: Exchange rate regime proposal, Keynesian theory and emerging countries.
JEL Classification: E12 and F33.

Introduction

The exchange rate regime that mainstream economists and international financial agencies, such as the International Monetary Fund (IMF), usually consider ideal for emerging countries is one with a largely unregulated capitals market, where capital mobility is absolutely unrestricted, and a perfectly flexible exchange rate (*World Economic Outlook*, 2002).

Under such a regime, domestic financial assets (securities) are regarded as perfect substitutes for international securities, and thus effective monetary policy is defined by parity between domestic and international interest rates, i.e. monetary expansion brings down domestic interest rates to levels below the international rate, leading to capital flight and consequent exchange rate devaluation, whose beneficial effects on current transactions come to generate an expansion in aggregate demand, which raises domestic interest rates until equilibrium is re-established in the balance of payments; symmetrical effects are produced by restrictive monetary policy.

Set against this, the need to preserve the autonomy of emerging countries' fiscal – and more importantly, monetary – policy (which, incidentally are fundamental to assuring their sustainable economic growth and harmonious social development) has reinforced the opinion of heterodox economists and some policy makers that what is needed is to introduce capital controls and an exchange rate regime that prevents excessive exchange rate fluctuations.

In recent years, the debate over exchange rate regimes (floating vs. managed) and maintaining or relaxing capital controls in emerging countries has once again become the centre of attention, mainly following developments from exchange rate and financial crises

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in Mexico (1994-1995), East Asia (1997), Russia (1998), Brazil (1998-1999) and Argentina (2001-2002)[1].

The main outcome of this debate is that implementing a free-floating exchange rate regime and ample capital mobility, even when backed by responsible or credible economic policy – in line with Washington Consensus prescriptions[2] –, leaves emerging countries prone to the humors and short-term logic of capital accumulation. The conventional argument on the difficulties facing such countries is to attribute the volatility of foreign financing to the irresponsible economic policies they adopt (Caramazza & Aziz, 1998). The heterodox view, meanwhile, regards floating exchange rate and high capital mobility as a destabilizing combination of factors that intensify exchange crises in emerging countries.

The intention of this paper is to propose, in the light of Keynesian theory, an exchange rate regime for emerging countries with the capability to mitigate their external vulnerability and fragility and their dependence on foreign capital, and thus assure macroeconomic stabilization – understood, following Keynes (1964: Chapter 24), as being the combination of price stability and full employment.

To that end, the paper is divided into three sections, in addition to this brief introduction. The next section revisits Keynes' thinking and proposals with regard to both exchange rate policy and capital mobility, with a view to showing how they contribute to maintaining full employment. The following section presents a strategy for an exchange rate regime with capital controls for emerging countries. Finally, some brief conclusions are offered.

1. Keynes' thinking and proposals on exchange policy and capital mobility

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[1] These exchange rate and financial crises yielded a consensus among academics and policy makers as to the need to restructure the international monetary system as an indispensable condition for the world economy, and particularly the emerging economies, to see a return to periods of expansion and economic prosperity. While there is a consensus that the international monetary system needs restructuring, the same cannot yet be said with regard to the mechanisms proposed to mitigate and/or put an end to instability in world exchange and financial markets. On this point, Eichengreen (1999, Chapters 6 and 7), Eatwell & Taylor (2000), Davidson (1994, Chapter 16, and 2002, Chapter 14) and Isard (2005, Chapters 7 and 8) offer a summary of the main options for restructuring the international monetary system.

[2] The neoliberal measures advocated for emerging countries by the Washington Consensus are as follows: (i) reduction or elimination of tariff barriers; (ii) free capital mobility, whether for foreign investment or for convertible currency transactions; (iii) fiscal discipline; (iv) tax reform; (v) financial deregulation; and (vi) privatizations.

Throughout Keynes' work there is a recurring concern with how to restructure the international monetary system[3] – and particularly the fixed-though-adjustable rate system (*à la* crawling peg) – and with the capital control mechanisms fundamental to assuring autonomous economic policy with a view to price stability and economic growth with full employment.

It is important to note that Keynes' theory was not divorced from economic realities nor from the practical issues of economic policy. Quite the contrary, his thinking and concepts were always conditioned by the economic changes of his time and were bound up with his activities as a policy advisor to the British government from 1910 to 1946. The exchange rate and capital controls issues are examples of this. On the one hand, on exchange rate policy, Keynes abandoned the proposal for a strongly rigid regime, such as the rules of the gold standard system, for a managed exchange rate policy, because he believed that exchange rate stability was of the utmost importance to stabilizing both the international monetary system and domestic prices. On the other hand, although Keynes initially favored free trade and full mobility for the factors of production, in view of the changes that occurred in the period between the Wars, he came to advocate protectionist policies and capital controls.

This section considers some selected studies to re-examine Keynes' ideas on exchange rate policy and capital flows.

1.1. Fixed-but-adjustable exchange rates and expansionist monetary policy

In *Indian Currency and Finance* (Keynes, 1971a), published in 1913, Keynes first sets out the possible advantages and disadvantages of the gold standard and gold-exchange standard monetary systems. Then, by reference to the Indian monetary and financial system, he proposes an international monetary reform based on a fixed-but-adjustable exchange rate regime and on gradually replacing gold as the international reserve currency. In making such a proposal (which, incidentally, points towards the system on which the gold-exchange standard monetary and exchange regime operates), the "flexibility" of the fixed exchange rate is deemed to leave monetary policy relatively free to stabilize overall

[3] For Keynes' ideas and proposals on reforming the international monetary system, see Ferrari Filho (2006, Chapter 1).

prices levels or, more importantly, to galvanize levels of income and employment, while the gradual replacement of gold as the international reserve currency by other internationally convertible currencies managed by national central banks would make for more elastic international liquidity[4]. Keynes went as far as to state clearly that the gold-exchange standard would be the "ideal currency of the future" (*Ibid*.: 25).

When the gold standard monetary system broke down[5] as a result of World War I, and in a context where all European currencies came to float freely, Keynes began to concern himself more explicitly with the possible impacts of exchange rate volatility on the operational dynamics of economic and financial relations in the world economy and on countries' (inflationary) monetary stability.

In this same direction, during the International Conference at Genoa in 1922, building on ideas presented in *The Stabilisation of the European Exchanges: a Plan for Genoa* (Keynes, 1977: 355-369), Keynes proposed a crawling peg-type system where the exchange rate could vary within a preset band of about 5.0%. With this fixed-but-adjustable exchange rate, Keynes intended not only to prevent external shocks and/or domestic inflationary and deflationary impacts from creating obstacles to equilibrium in the balance of payments, but more importantly to mitigate excessively speculative action by economic agents in relation to the dynamics of futures prices resulting from their uncertainties as regards forward exchange rate pricing.

In *A Tract on Monetary Reform* (Keynes, 1971b), published in 1923, Keynes' analysis moves towards the idea above. He argues that, in the short term, the level of unemployment and the speculative nature of the world economy derive from monetary instability, with the idea that price stability should be the basic aim of economic policy and, more specifically, monetary policy. In that regard, he believed that exchange rate policy should be subordinated to the dynamics of price stabilization monetary policy.

Keynes felt that, given the impossibility of monetary authorities' holding domestic prices stable by making active use of open market operations, a slightly "flexible" exchange

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[4] Keynes felt that no longer could trade and financial transactions in the international monetary system be based solely on gold, because its elasticity depended on discovering, and thus on the technology for prospecting, new gold deposits. In his words, "we shall leave permanently the most intimate adjustments of our organism at the mercy of a lucky prospector (…) or a change of ideas in Asia" (Keynes, 1971a: 71)".

[5] The gold standard system was abandoned at the start of the First World War. In the 1920s, there were some attempts to restore it in specific countries, such as the United Kingdom.

rate policy was indispensable to assuring autonomous monetary policy. Thus, Keynes wrote: "when stability of the internal price level and stability of the external exchanges are incompatible, the former is generally preferable" (*Ibid*.: 132).

The fact that Keynes suggested subordinating exchange rate policy to monetary policy does not mean to say, however, that he ceased to be concerned with exchange rate stability. Quite the contrary, Keynes felt, on the one hand, that price stability was fundamental to keeping the real exchange rate relatively stable, in accordance with parity purchasing power and, on the other, that "the Bank of England (...) [could] '[*r*]*egulate*', but not '*peg*' [exchange rate]. The Bank of England should have a buying and a selling price for gold (…) and this price might remain unchanged for considerable periods" (*Ibid*.: 149-150, italics added).

In *A Treatise on Money* (Keynes, 1976), published in 1930, Keynes analyzed the advantages and disadvantages of various alternative exchange regimes. He regarded this discussion as relevant in that adoption of a given exchange regime by one or more countries entailed the dilemma of how: "to preserve the advantages of the stability of the local currencies of the various members of the system in terms of the international standard, and to preserve at the same time an adequate local autonomy for each member over its domestic rate of interest and its volume of foreign lending" (*Ibid*., Volume 2: 304).

On that occasion, Keynes proposed setting up a Supernational Authority to manage the value of gold in accordance with a crawling peg-type exchange regime where "each [country] [could] vary the value of its local money in terms of gold within a range of (say) 2 per cent" (*Ibid*., Volume 2: 338).

In *Notes on the Currency Question* (Keynes, 1982: 16-28), a paper written immediately after England abandoned the gold standard monetary system and which would, consequently, come to underpin his participation in the 1931 World Economic Conference, Keynes offered two exchange policy proposals which continued closely related to the ideas set out in *A Treatise on Money*, that is: a crawling peg system and fixing the pound sterling in terms of a price standard (*Ibid*.: 26-27).

In parallel with this, he proposed an Anglo-American currency stabilization agreement under which exchange rate movements would accompany international price variations[6].

In *The Means to Prosperity* (Keynes, 1972: 335-366), after describing gold as "a barbarous relic", Keynes presents a proposal for reforming the international monetary system entitled *Gold-Notes*, where:

> "each participating country should adopt a *de facto* parity between gold and its national currency, with buying and selling points for gold separated by not more than 5 per cent (…). The *de facto* parity should be alterable, if necessary, from time to time if circumstances were to require" (*Ibid*.: 362).

In the early 1940s, when developing his International Clearing Union (ICU)[7] – a proposal for restructuring the international monetary system in such a way that the world economy after World War II would assure conditions for full employment – Keynes recommended that participating countries should adopt a regime of exchange rates that would be fixed, but adjustable, in relation to the international – *bancor* – currency (Keynes, 1980: 170). He argued that exchange rate fluctuations should be discrete – in intervals of at most 5.0% for both deficit and surplus countries – with a view to righting any temporary balance of payment disequilibrium. In Keynes' words:

> "We need an orderly and agreed method of determining the relative exchange values of national currency units, so that unilateral action and competitive exchange depreciations are prevented (…). The proposal is to establish a Currency Union, here designated an *International Clearing Union*, based on international bank money, called (let us say) *bancor*, fixed (but not unalterably) in terms of gold and accepted as the equivalent of gold" (*Ibid*.: 168-170).

In summary, from a brief examination of Keynes' thinking and proposals with regard to exchange rate policy, two points stand out clearly: firstly, Keynes felt that

[6] The basic idea of this proposal, grounded in *The Chaos of the Foreign Exchanges* (Keynes, 1982: 259-263), was that exchange rate variations should accompany the inflationary disparity between the US and British economies.

[7] The ICU was the plan proposed by the British during discussions on restructuring the international monetary system at the 1944 Bretton Woods conference.

exchange rate stability was fundamental to assuring price stability and, secondly, he argued that a regime of fixed-but-adjustable exchange rates could be adopted both in a world of highly mobile capital flows and in a world where such mobility was restricted. In other words, Keynesian analysis regards more or less managed exchange rate regimes as serving the purposes of macroeconomic stability, understood as the combination of controlled inflation and sustainable economic growth.

1.2. Capital controls and autonomous economic policy for full employment

In *The General Theory of Employment, Interest and Money* (*GT*), Keynes shows that in monetary economics, fluctuations in effective demand and level of employment occur because, in a world where the future is uncertain and unknown, economic agents prefer to withdraw currency, and consequently their decisions to spend, whether on consumption or investment, are postponed. In other words, agents withhold currency as a kind of safeguard against the uncertainty entailed by their precarious knowledge about expected yields from their production plans.

Given that monetary economies do not necessarily converge to a position of market equilibrium, extra-market interventions, such as control and regulation, are fundamental to "containing the immanent tendencies to disintegration inherent to the market economy" (Carvalho & Sicsú, 2006: 15) and thus creating the conditions conducive to development of an institutional environment favorable to economic agents' decision making.

While market intervention is necessary in closed economies, there is even more call for regulation and control at the international level, where trade and financial transactions involve a variety of currencies and, therefore, uncertainty is far greater.

With reference to the above idea, all Keynes' proposals for reform of the international monetary system can be seen to have a common aim: for an international market maker to set up an international liquidity currency able to underpin economic agents' expenditure decisions, both on consumption and investment, thus ceasing to be a speculative asset amenable to hoarding. In other words, in Keynes' view, although the international liquidity currency would be an asset with the properties and characteristics of a monetary asset, its purpose would be (i) to foster the elasticity necessary to expanding production and world trade and (ii) bring in the funds necessary and sufficient for the process of short-term balance of payments adjustment, thus galvanizing effective demand globally.

Among the various proposals Keynes put forward for reforming the international monetary system, the ICU is the most highly developed. Keynes argued that the discussions on restructuring the international monetary system should focus on setting up a world central bank (ICU), which would issue an international liquidity currency with a stable value standard. This institution should be able to (i) set monetary and exchange rules, (ii) discipline trade policy, (iii) reorganize market dynamics in terms of the behavior of production, distribution and prices, (iv) regulate external investment, i.e. both venture and portfolio capital flows and (v) signal rules for adjusting balance of payments (1980: 233-234). In other words, as Keynes regarded monetary economies as inherently unstable[8], in order for economic agents' contractual decisions on spending to be taken in a less uncertain and unpredictable context, thus enabling effective demand to expand at the world level, it was indispensable to restructure the international monetary system on the basis of an international market maker able to perform the functions set out above.

This is the direction taken by Davidson (1994, 2002), who builds on a taxonomy of his own, where the monetary dynamics among open economies may be of two types: unionized monetary system (UMS) or non-unionized monetary system (NUMS), to present a proposal for reform of the international monetary system called the International Money Clearing Union (IMCU). The idea consists in showing that Keynes' proposals for restructuring the international monetary system, and more specifically for creating an international reserve currency managed by an international market maker, converge to a system with the characteristics of a UMS, that is: a relatively fixed exchange rates in relation to the international monetary standard; monetary contracts expressed in the international reserve currency; and a monetary policy designed to assure more flexible international liquidity. Increasing the IMCU's role in the world economy would be designed to prevent crises in effective demand, provide trigger mechanisms for automatically adjusting balance of payment disequilibrium, enable each nation to

[8] According to Keynes (1973: 411), "booms and depressions are phenomena peculiar to an economy in which (...) money is not neutral".

implement capital flow controls, and expand the amount of international liquidity (Davidson, 1994: 268).

Items (iv) and (v) of the ICU (above) are the conditions by which, according to Keynes (1980: 176), “[t]he plan aims at the substitution of an expansionist, in place of a contractionist, pressure on world trade”.

As regards the capital flow controls, Keynes argued that:

> “control of capital movements, both inward and outward, should be a permanent feature of the post-war system (...). The advocacy of a control of capital movements must not be taken to mean that the era of international investment should be brought to an end. On the contrary, the system contemplated should greatly facilitate the restoration of international credit for loan purposes (…). The object (...) is to have a means of distinguishing – (a) Between movements of floating funds and genuine new investment for developing countries (…) and (b) Between movements, which will help to maintain equilibrium, from surplus countries to deficiency countries, and speculative movements or flights out of deficiency countries or from one surplus country to another” (*Ibid*.: 185-187).

Keynes regarded capital controls as essential to preserving the autonomy of monetary policy. In his words, “the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world” (*Ibid*.:149).

As regards the idea that the costs of balance of payment adjustments should be distributed among the two groups of countries (deficit and surplus), Keynes opposed the gold standard approach to the monetary system, where the whole onus of external adjustment fell to the deficiency countries. He argued that:

> “[i]t should be much easier, and surely more satisfactory for all of us, to enter into a general and collective responsibility, applying to all countries alike, that a country finding itself in a creditor position *against the rest of the world as whole* should enter into an arrangement no to allow this credit balance to exercise a contractionist pressure

> against world economy and, by repercussion, against the economy of the creditor country itself" (*Ibid*.: 178).

To conclude, implementation of a proposal for restructuring the international monetary system under the conditions advocated by Keynes would be intended to assure the organization of markets worldwide. In Keynes' words (*Ibid*.: 190-191), the ICU "could use its influence and its powers to maintain stability of prices and to control the trade cycle".

2. Crawling peg-type exchange regime and capital controls: a strategy for the emerging countries

Since the Bretton Woods international monetary system collapsed in the early 1970s, the process of globalization, characterized by increasing international mobility of capital and financial deregulation, has substantially altered the dynamics of the world economy. Moreover, in the absence of macroeconomic policies to stimulate economic growth and limit the destabilizing movements of capital flows, international venture capital flows have created serious monetary and exchange problems for the world economy, especially for the emerging countries[9].

The institutions of the "globalized era" do not forewarn economies of impending monetary and exchange crises and there is no political consensus on restructuring the international monetary system. In that light, the need to preserve the autonomy of countries' – and particularly emerging countries' – fiscal and monetary policy, which are regarded as fundamental to assuring sustainable economic growth paths, has reinforced the opinion of some economists and policy makers that what is needed is to introduce an exchange rate regime that prevents excessive exchange rate fluctuations and to implement capital control regulations.

In response to the idea above and in line with Keynes' thinking and proposals presented in the second section above[10], it is felt that fixed-but-adjustable exchange rate

[9] The adoption of floating exchange rate regimes and free capital mobility by emerging countries has destabilized their currencies and leveraged exchange crises there, because their external fragility and vulnerability and dependence on foreign capital make them inherently unstable.

[10] Contemporary monetary and exchange problems are much more complex than those observed by Keynes decades ago. That is, the global economy of recent years is characterized, among other things, by excessive exchange volatility, the almost perfect mobility of capital, United States' balance of payments deficits –

regimes and imperfect capital mobility are more appropriate to emerging economies, because they make for the autonomous domestic economic policy necessary to assure full employment in these economies.

In that regard, the need to keep exchange rates less volatile and more competitive in international trade terms warrants the adoption of intermediate exchange regimes – such as bands, target zones, and a crawling peg-type system – because such regimes afford the flexibility necessary for adjusting to shocks, but at the same time afford the possibility of orienting the trajectory of exchange rates over time. For such exchange rate regimes to function properly, so as both to avoid speculative attacks and to increase monetary authorities' effectiveness in determining exchange rates, may require the adoption of a regime of restricted capital account convertibility, i.e. the introduction of capital flow regulations.

Adopting an exchange rate under a crawling peg system is designed to mitigate business uncertainties relating to the volatility of exchange futures contracts and thus to expand both internal and external effective demand in emerging economies. The idea consists in setting an *ex-ante* exchange rate fluctuation band so that the monetary authority can intervene in the market whenever the exchange rate approaches extreme values at the upper or lower limits of the prefixed band. Placing limits on exchange rate fluctuations is thus designed to influence the expectations of economic agents by seeking to reduce the volatility of nominal exchange rates and intervene in their trajectory over time, i.e. to have an influence in setting the real effective exchange rate (REER).

At the same time as a crawling peg-type exchange rate regime is introduced, capital control mechanisms have to be imposed preventively on the capital and financial accounts, using for that purpose an efficient, modern system of capital flow regulation (Paula, 2003; and Carvalho & Sicsú, 2006). As a rule, capital controls can take three forms: (i) administrative controls, i.e. quantitative restrictions on capital flows, depending on their origin, maturities and destinations; (ii) compulsory deposits on incoming capital flows; and (iii) financial regulations, i.e. limits imposed on residents' exchange positions.

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incidentally the United States are still responsible for the elasticity of international liquidity – and speculative activities on financial markets.

Proposals for capital controls range from a suggested international agreement to introduce a single tax on capital flows (the "Tobin tax"), the basic idea of which is to throw "sand in the wheels" of the financial market, to paraphrase an analogy accepted worldwide (Eichengreen, Tobin & Wyplosz, 1995), through to measures such as the taxing of capital inflows and minimum timeframes for capital to remain in the country (so-called "holding periods"). Grenville (2000: 60), for example, describes capital control use as extending from the model adopted by Chile (holding) through to the model used by Singapore, which limited banks' freedom to lend local currency to non-residents, hindering speculators from taking positions in domestic currency. He also suggests that prudential controls be adopted so as (i) to limit opportunities for residents to borrow in foreign currency and (ii) to maintain strong restrictions on banks' ability to open positions in foreign currency or to increase their exposure in foreign currency through exchange rate-indexed loans.

Therefore, capital controls in emerging economic have two aims: on the one hand, restricting capital flows means reducing demand for assets in internationally convertible currency, thus significantly reducing the potential for speculation against the exchange rate; and, on the other hand, by preventing excessive exchange rate fluctuation, greater autonomy is gained for monetary policy.

3. By way of conclusion

In the 1980s and 1990s, economic globalization substantially altered the nature and determinants of world economic dynamics: more open economies, deregulation of balance of payments financial and capital accounts and, consequently, freely mobile portfolio capital; deregulation of domestic financial markets and financial innovations and liberalizing structural reforms – e.g. to state assets and the social security system, with a view to downsizing the public sector, and labor – both limited the action of nation-states' macroeconomic policies and were among the main causes of frequent balance of payment crises and recurring speculative attacks on emerging countries' national currencies and of cyclic fluctuations in effective demand, thus leading to rising rates of unemployment on the world economy, concentration of income and capital, and social exclusion, a phenomenon typical of the contemporary world. As a result, due to (i) the significant increase in the volume and speed of fund transfers on the international financial market, (ii) the blurring of boundaries between markets and (iii) greater integration among financial markets worldwide, the economic dynamics of those decades came to be known as the process of financial globalization[11].

This globalization, in turn, tends by it very nature to disrupt not only domestic markets, but whole countries, especially emerging countries, by establishing a kind of extended financial casino. Keynes, in Chapter 12 of his *GT*, sees strong connections between the real and financial sectors of the economy. One such connection is the impact of speculative activities on production activities, and especially on investment. To quote a passage from *GT* in which Keynes identifies a connection between the real and financial sectors of the economy:

> "the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done" (Keynes, 1964: 159).

This paper shows that – as recommended by Keynesian theory – in a context of financial globalization, i.e. greater economic interdependence and more intense inter-country capital flows, conditions must be created in order for national economic policies to be operationalized autonomously. On this point, in view of the lack of any institutional arrangement for international monetary cooperation to organize the world economy, emerging countries' response to economic globalization depends on their introducing (i) mechanisms to permit exchange rate management to assure domestic policy objectives and promote a more predictable environment for productive investment and productive activity in general and (ii) capital controls to preserve the autonomy of their economic, and especially monetary, policies.

Corroborating the idea above, Ferrari Filho & Paula (2006: 219) show that, for example, "China and India, administrating their exchange rate regimes with restricted capital account convertibility, are cases of more or less successful macroeconomic policy management (...) [while] the more clearly liberal economic policy strategies adopted in the Brazilian economy (...) have not managed to assure the country sustainable growth".

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[11] One consequence of this process is the tendency for a single world money and credit market to be established. In this regard, see Ferrari Filho & Paula (2004).

To close, it is important to add that managed exchange regimes and capital controls are not ends in themselves, but are means to achieving economic prosperity, full employment and more equitable income distribution among individuals and among countries. In this context, according to Davidson (1997: 672) "what is necessary is to build permanent fireproofing rules and structures that prevent 'beauty contest' induced currency fires. *Crisis prevention rather than crisis rescues must be the primary long-term objective*".

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