

Exchange Rate Regimes as a Tool to advance Reforms --- Success or Failure?

*Who will provide the next Financial Model?
Asia's Financial Muscle and Europe's Financial Maturity*
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- I. The EU's choice of exchange rate regime and efforts at reform
- II. Governance and crises
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Conclusions

- I. The euro did not function as a tool to advance reform as expected
- II. If the crisis results in successful governance overhaul (at EU and member state levels), then we may be able to say it did
- III. Even if the euro "disintegrates", a similar exchange rate regime will start again

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Reasons for the euro

1. As the "logical consequence of the single market"
2. For Europe to have an international currency equal to the US dollar and different from the Deutsche Mark
3. To encourage structural reform

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Reasons for the euro

Why would the euro encourage structural reform?

- By “hiring a conservative central banker” and “a more conservative fiscal authority”
- By increasing price transparency

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EU-level efforts to advance reform

The Lisbon Agenda (Strategy)

launched at the Lisbon European Council (Summit) of 23rd and 24th March 2000

a ‘new strategic goal’ for the next decade for Europe ‘to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion’

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EU-level efforts to advance reform

The re-launch of Lisbon: March 2005

the EU chose to keep applying the principle of subsidiarity and the Open Method of Co-ordination (OMC), and to ‘increase the sense of ownership’ of the Lisbon Strategy

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EU-level efforts to advance reform

Europe 2020: March 2010

To make Europe “a smart, sustainable and inclusive economy delivering high levels of employment, productivity and social cohesion”

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EU-level efforts to advance reform

--- slides from 2010

Reform is encouraged,
using Open Method of Co-operation

i.e. No penalties, only peer pressure

- For Europe to have a vibrant economy, markets need to become more flexible and conducive to innovation and job creation
- Without the right incentives, voters will not accept the necessary changes

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EU-level efforts to advance reform

--- slides from 2010

So if the OMC is to be improved,
how do we ensure that members accept and enforce it?

1. Can the right incentives be introduced without hurting sovereignty?
2. If some citizens of a democracy prefer not to, should they stay in the EU?
3. Is a union kept together for the sake of keeping it together a good thing?

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EU-level efforts to advance reform

The current crisis provides ample evidence that the answer to question 1 above was "no"

Reforms, if they took place at all, did not sufficiently increase competitiveness in many Member States

Incentive for reform that did not hurt sovereignty was not strong enough

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EU-level efforts at "Governance overhaul"

The EU is now keenly aware of the need for "governance overhaul" and is not doing nothing

- The Van Rompuy task-force
- Merkel-Sarkozy "fiscal compact" to introduce "strict fiscal rules and automatic sanctions"

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Governance and Crises

The fundamental cause of the crisis was **governance failure**,

the euro had a structure whereby it could not continue if one of its own goals was missed

- Governance in the member states did not bring about the reforms necessary to recover competitiveness
- Governance at EU level did not ensure convergence towards competitive economic structures

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Governance and Crises

Democracy can fail

as a **bond-issuer**

and as a **medium of economic vitality**

- Technocrat governments in Greece and Italy, actually popular in latter
- Collaboration between Merkel and Sarkozy towards centralised fiscal rules

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Why this is a question of governance
--- slides from 2010

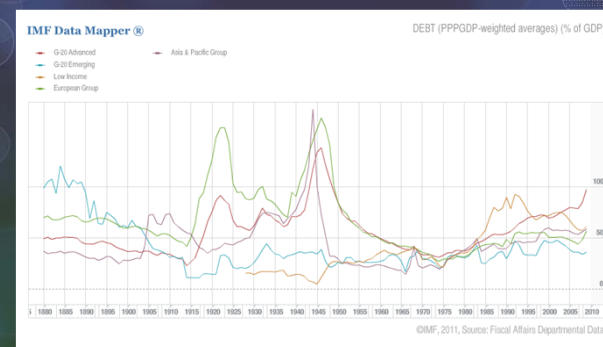
This is about governance that enables policy discipline and avoid excess leverage, at national level or EU level or global level

G20 advanced nations' debt levels are highest in peacetime history

Since WWII, debt levels have been rising, reflecting the welfare state

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Why this is a question of governance



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Why this is a question of governance
--- slides from 2010

Recipe for a bubble and lost decades:

1. 'mature' economy
2. want to try to increase growth
3. want to avoid painful reforms

This is the biggest lesson from Japan in the post-war years

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Why this is a question of governance
--- slides from 2010

The only way to reduce unemployment in such economies is to conduct reform, introduce flexibility and foster new businesses

Aim at 'opportunity'
rather than 'growth' per se

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Why this is a question of governance
--- slides from 2010

BUT

Such economies prefer to rely on fiscal and monetary expansion

BECAUSE

Voters would only **vote for** politicians who promise them **painless growth**

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Why this is a question of governance
--- slides from 2010

Isn't fiscal policy supposed to work?

Yes, but...

Today, fiscal policy is less effective in increasing aggregate demand because

- Taxpayers anticipate future tax hikes
- Less productive infrastructure left to build
- The population is ageing

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Why this is a question of governance
--- slides from 2010

In addition,

leverage is more dangerous because

- New financial instruments and information technology allow borrowing on a larger scale, more quickly and extensively
- Government spending/borrowing rises easily but falls with difficulty

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Why this is a question of governance
--- slides from 2010

What about monetary policy?

Monetary policy is also less effective because

- Fighting deflation is like pushing on a string
- Monetary policy must aim at two goals, price stability and market stability

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Why this is a question of governance
--- slides from 2010

Monetary policy is also less effective because

- Money supply is becoming more difficult to control with increased international flow of capital
- Leakage of policy increases with economic interdependence and financial/technological innovation

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Why this is a question of governance
--- slides from 2010

The solution?

The best we can do is

- encourage flexibility and innovation
- have sound fiscal balances and stable prices in preparation for emergencies
- minimise the risk of another crisis and its extent by effective regulation

For that, **governance must improve**

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It's the governance, again

This brings us back to the question:

Can exchange rate regimes work as a tool to advance reform?

No, so far, but if the governance overhaul underway succeeds in bringing stable prosperity, yes

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It's the governance, again

If this single currency (euro) "disintegrates", before long member states will peg their currencies to what remains of the euro

Whether the same story is repeated depends on how successful is the governance overhaul

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It's the governance, again

The question of governance are relevant to the rest of the world, in particular Asia which is discussing its own integration

How much sovereignty can/should a country maintain, in terms of fiscal policy, macroprudential regulation, social security?

These are questions that other nations will be asking in the coming years, with the continued progress of globalisation

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It's the governance, again

A radical re-think is necessary, not only in Europe but all over the world about how democracy functions, how and whether to maintain the welfare state that everyone in the rich world has come to take for granted.

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To answer any of these questions...

We need to reconsider governance

The issue is bigger than the euro

Europe still is a leader and model

that shows the rest of the world

what happens when nations try to

integrate themselves under
supranational institutions

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Fixed Exchange Rates and Crises

--- slides from 2010

The euro area is 'disintegrating'

not from the centre but **the periphery**
because some members could not keep
up with German-style policy discipline

The Bretton Woods system

disintegrated because the country at
the **centre**, the USA, conducted
monetary policy **without discipline**

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Fixed Exchange Rates and Crises

--- slides from 2010

Without **discipline** at the centre,
the fixed exchange rate/currency union
would disintegrate from the centre

Without **discipline** at the periphery,
the fixed exchange rate/currency union
would disintegrate from the periphery

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Fixed Exchange Rates and Crises

--- slides from 2010

Granted, there are benefits and costs that arise
only in a currency union:

○ Benefits:

the loss of credibility by the periphery leads
to currency depreciation even for the centre

○ Costs:

the need to share the burden of bailing out
banks and governments in the periphery is
more acute

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Fixed Exchange Rates and Crises

--- slides from 2010

But **even without the euro**,

if governments and/or banks in some members of even a semi-fixed rate regime lost credibility, stronger members cannot do nothing

Economic interdependence dictates that, **with or without a single currency**, countries have no choice but to **bail out their trade/investment partners**

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Fixed Exchange Rates and Crises

--- slides from 2010

Therefore, the euro is not the cause

Members of a fixed exchange rate **OR** currency union have no choice, at both the centre and periphery,

they need to adopt both

monetary and fiscal discipline

in order to **avoid excess leverage**

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Why crises are repeated

--- slides from 2010

Financial markets are **unstable by nature**

- Low transaction costs
- Asymmetric information
- Moral hazard

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Why crises are repeated

--- slides from 2010

Constraints faced by monetary authorities

- Cannot simultaneously aim at price stability and market stability (Tinbergen's theorem)
- Fixing exchange rates under free capital flows means loss of monetary policy autonomy (Inconsistent triangle)
- Fixing exchange rates means loss of nominal devaluation as policy tool

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Why crises are repeated
--- slides from 2010

Limits of financial regulation

- Regulatory arbitrage
- Tighter regulation tends to discourage financial intermediation
- New financial instruments to evade regulation will always be developed as long as there is risk

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Why crises are repeated
--- slides from 2010

From financial to economic crisis

- Exchange rate swings disrupt trade and investment
- Raising interest rates to stop exchange rate depreciation is recessionary
- Reducing fiscal deficits to restore credibility is recessionary

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Why crises are repeated
--- slides from 2010

From economic crisis to lost decades

- Uncertainty discourages spending
- Both prices and deficits can get into a downward spiral
- Beggar-thy-neighbor situations can arise without the ability to devalue

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Japan's Crisis in the 1990s
--- slides from 2010

Number of major banking groups:
21 → 8 in 3 years

The ratio of 'loans under risk management' to total loans :

- over 5% for city banks
- over 7% for regional banks
- over 8% for second-tier regional banks in mid-FY 2000

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Japan's Crisis in the 1990s
--- slides from 2010

The highest estimate of unrecoverable debt for Japan: 150 thousand billion yen, 30% of GDP

12.5 thousand billion yen was injected into private banks since 1998

(As of 31st March 2009, the government recovered **9.4 thousand billion yen** by disposing of preferred stocks)

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Japan's Crisis in the 1990s
--- slides from 2010

For the Japanese economy as a whole, the burst of the bubble had a cumulative effect of **draining ¥1,000 thousand billion** (2 years' worth of Japanese GDP)

1/5 of this loss is estimated to have been borne by the **financial sector**

(OECD Economic Surveys Japan, 1998, p. 4)

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Japan's Crisis in the 1990s
--- slides from 2010

The Japanese government's fiscal packages between August 1992 and January 2003:

- **13** packages

- cumulative spending of about

¥ 140 thousand billion

(equivalent to roughly 30% of Japanese GDP)

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