Twin fallacies about exchange rate policy: A note

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To assert that some countries are subject to irrational discrimination on the part of global investors pushes off responsibility to others and delays the institutional reforms necessary to make real progress.

Two assertions about exchange rate regimes circulate with some frequency in policy circles. The first, which could be called the hypothesis of the excluded middle, holds that authorities must either choose perfectly floating exchange rates (preferably anchored by an inflation target for the central bank) or a hard (preferably irrevocable) peg. In the former camp tends to be the small number of industrial countries with sufficient credibility to run independent monetary policies. In the latter camp are mostly emerging market economies that have so little credibility in the financial marketplace that adopting another country's currency seems like a small sacrifice of autonomy.

The second, seemingly unrelated, notion attempts to explain why policy makers in some countries have little credibility. In several papers, Ricardo Hausmann has argued that the inability of emerging-market economies to exercise monetary independence owes to the severe mistrust that they are perceived with by global investors. That mistrust, exemplified by the inability of emerging market economies to borrow at long maturities in their own currencies,

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transcends current fundamentals and traces back to the failure of prior policy makers. Hausmann dubs this "original sin" to emphasize that this lack of credibility is a taint unrelated to actions or incentives of the current crop of authorities.

Reinhart and Reinhart (2003) argue that the theories of the excluded middle and original sin are twin and related fallacies that are contrary to theory and evidence. The sense that credibility problems stem from a simple and irrational source–failures of prior generations of policy makers–lends credence to alternative regimes that seem to allow the easy purchase of investor confidence–an exchange rate regime at one of the corners. Two decades of theory and empirical evidence cumulate to argue that this is too simple an answer. As to the theory, the literature on time inconsistency has amply demonstrated that the inability to precommit future policy decisions gives reason to doubt that the current regime will be maintained. That doubt stems, not from the record of prior failures, but from the inconsistency of incentives in the future.

As to the evidence, Calvo and Reinhart (2002) have documented the record of what authorities actually do rather than what they report and have found that the excluded middle is crowded indeed.[2] Many exchange rate regimes–particularly in emerging market economies–exhibit limited flexibility. That is, the variability of exchange rates is damped relative to a typical asset price but not so small as to be considered a peg. These very dirty floats or quite soft pegs seem to reflect an unwillingness on the part of authorities to trust the foreign exchange

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[2] Calvo, Guillermo A. Reinhart and Carmen M. Fear of Floating, *Quarterly Journal of Economics*, May 2002, v. 117, iss. 2, pp. 379-408.

markets enough to either float freely or to be fixed. For Calvo and Reinhart, this is evidence of a "fear of floating."

The next section provides some stylized evidence that suggests policy makers in many emerging market countries, especially in Latin America, do face investor objections that would seem consistent with original sin. That section then takes what might seem like a detour in an economics paper by examining early Christian thought on original sin. However, this digression shows that a consistent interpretation of the doctrine stresses that the "stain of Adam" made people fallible so that their *future* actions cannot be counted on. Hence, original sin provides a rational warning about the future, not an irrational stigma from the past.

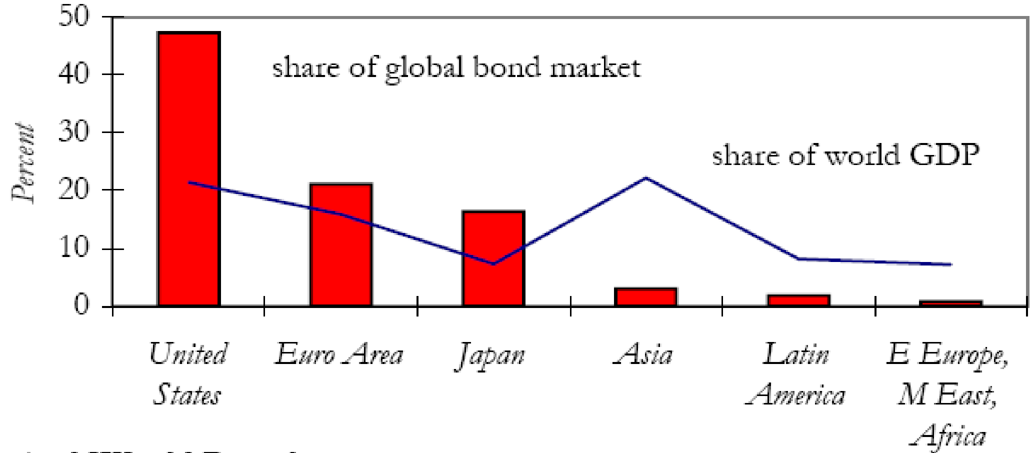
I. Unequal Market Access and Original Sin

We focus on emerging economies because their experience has, unfortunately, provided ample evidence of the withdrawal of global investors. Three pieces of evidence establish this record.

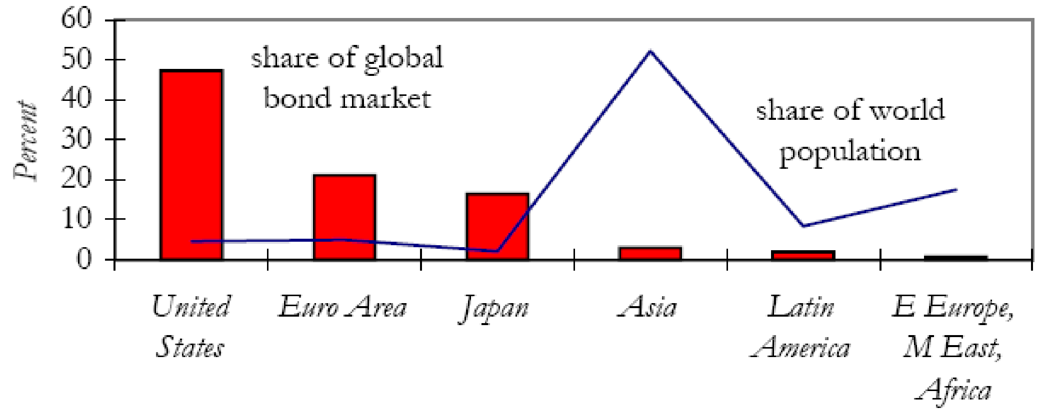
Figure 1 shows recent calculations of the distribution of bonds on the global market by original issuer (as related in the International Monetary Fund's *Global Financial Stability Report*, 2002). In most model of optimizing portfolios, the amount of debt outstanding should be proportional to income. That is, we should expect that shares on the global bond market should approximate shares of world GDP. As is evident in the solid line at the top panel, industrial countries are considerably overrepresented on the world market, with the United States' presence about double its proportion of world income. Since global shares have to sum to 100 percent, the industrial counties' overages are mirrored by the small participation on the global debt market of emerging markets, especially developing Asia but also including countries in the Western Hemisphere.

Figure 1: Share of the Global Bond, 2001

And World GDP



And World Population

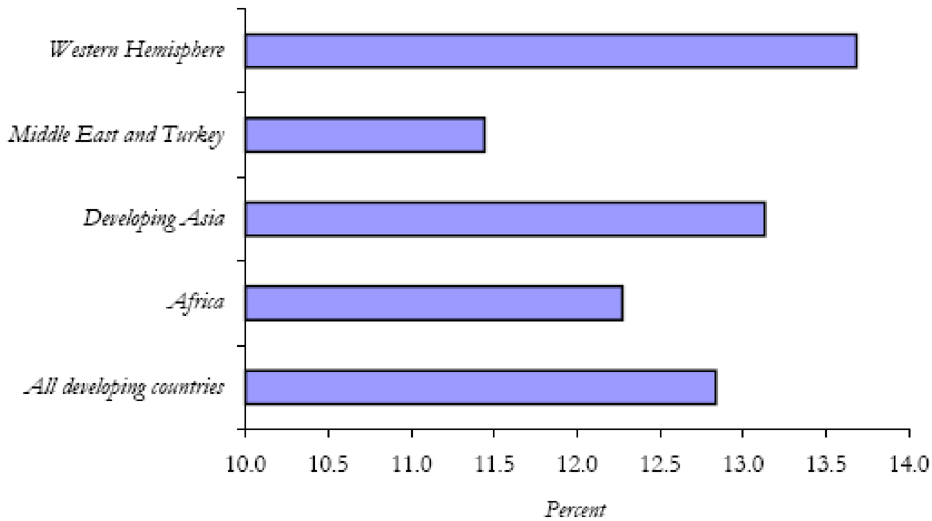


Source: (lines) *IMF World Economic Outlook* (9/02) and (bars) *Global Financial Stability Report* (10/02)

Reflecting this limited participation in global bond markets, issuers in emerging markets have found it relatively more advantageous to rely on shorter maturities. As shown in Figure 2, which is based on data from the International Monetary Fund's *World Economic Outlook* (IMF, 2002), this holds with particular force for the developing countries of the Western Hemisphere.

About 14 percent of the external debt of those nations, on average over the past eight years, had a short maturity, the highest share of the major developing country groups.

Figure 2: Share of Short-term in Total External Debt, 1994 to 2002



Source: IMF, World Economic Outlook (9/02)

Despite this relatively short maturity, the historical record shows that developing countries, particularly in the Western Hemisphere, have paid a higher rate on their external debt than the other main groups of developing countries and that rate is especially volatile for countries in the Western Hemisphere. In part, the higher and more volatile rate reflects a smaller proportion of official aid at preferential rates in the total. But some portion of the higher and more volatile interest cost evidences a distaste on the part of global investors for the obligations of developing countries of the Western Hemisphere.

Why so? In a series of papers written alone or with coauthors, Ricardo Hausmann has offered a simple explanation for the inability of emerging market countries to exert their presence on global financial markets. In particular, the evidence that developing countries cannot borrow abroad in their own currencies or at longer maturities in any currency is taken to mean that global investors attach some stigma to current governments as a result of the failure of previous governments. This market failure creates the maturity and currency mismatches on balance sheets in emerging market economies that are central to episodes of financial crisis and contagion.

At the sake of taking what appears to be an unconventional approach, we will spend a little time examining what the doctrine of original sin meant to the framers–Christian saints of the early millennium. Understanding what original sin meant in its original context will reveal an important inadequacy in its modern incarnation. In particular, early Christian scholars devoted considerable attention to explaining why a just God would punish the children of Adam for transgressions in the Garden of Eden. This literature can be roughly summarized as offering a three-part syllogism:

1. Because of Adam's sin, all his children are mortal and fallible. In the Epistle to the Romans, St. Paul explained that "... for as by the disobedience of one man, many were made sinners ..."
2. As a result of that original sin, all people now alive share the fallibility of Adam. St. Thomas Aquinas offered that the role of the individual should be seen as that as a part of society, or that "... an individual can be considered either as an individual or as part of a whole, a member of a society ... Considered in the second way, an act can be his

although he has not done it himself, nor has it been done by his free will but by the rest of society or by its head. . ."

3. As a logical consequence of the prior two propositions, we know that people are fallible, and those counting on their good behavior should be wary. The Christian scholar most associated with the doctrine of original sin, St. Augustine of Hippo, offered that "not what your ancestors have wrought but what you have thought is what matters."

St. Augustine's doctrine is a forward-looking proposition of considerable depth. In it is a sense that the past is past. Only the part of experience that might predict future behavior is relevant for current experience. There is no stigma or stain in St. Augustine, only an appreciation of the evil that fallible people may do in the future.

II. Exchange Rate Determination at the Corners

Our discussion of the true nature of the doctrine of original sin suggests that we should look for the problem of credibility in the possibility of future folly rather than some perceived stain from the past. Reinhart and Reinhart (2003) provide a model in which the government can choose policies consistent with either a pure float anchored by a constant money stock or a pure peg but, under certain circumstances, fail to find exchange rate stability at either corner. The problem is that the current government faces an election at a later date, and the possibility that its successors may behave less admirably will weigh on investors' current behavior. The difficulties imparted by this expectation channel in an otherwise standard model shows both why looking back to explain credibility problems is looking the wrong way and why so few economies adopt an exchange rate regime at a corner. By making the probability of regime change dependent on conditions in the foreign exchange market, the possibility of a transition to a bad central banker will complicate–indeed, potentially thwart–the efforts of the good central banker at either exchange-rate corner, a pure float or a pure peg. Thus, an understanding of the inability of policy makers to precommit the actions of successors–to St. Augustine, the fallibility introduced by original sin–helps to explain why the excluded middle is in fact so crowded.

III. Conclusion

We have argued that the notion of original sin has furthered interest in pinning the exchange rate regime to a corner, either a pure float or a pure peg. If policy makers in some emerging market economies are indelibly stained by the past mistakes of others, they will never be trusted by markets to exercise discretion wisely. Our reading is different: The legacy of those who defaulted was not an irredeemable stain that sets them apart from others in otherwise similar circumstances. Rather, their legacy was weak institutions, a lack of political comity in part associated with an unequal distribution of income, and a capricious attitude toward the rule of law. Such attitudes made the initial default possible and, as that legacy is handed down to subsequent generations, now makes future defaults and other forms of expropriation more likely.

To assert that some countries are subject to irrational discrimination on the part of global investors pushes off responsibility to others and delays the institutional reforms necessary to make real progress. Seeing the problem as a deep-rooted inability to commit in advance so that good near-term behavior may not be viewed as likely to be sustained implies that there may be no easy answer to the problem of recurring financial crises in emerging markets. But that is probably a more realistic answer.

In the presence of an important expectations channel–which the simple model presented in Reinhart and Reinhart (2003) suggests is highly nonlinear–policy makers might see being somewhat ambiguous in describing their current regime as constructive. Some discretion–whether called a dirty float or a flexible peg–may give them the ability to lean against such expectational shocks. Moreover, such ambiguity may make defining success or failure harder, thereby militating against voter backlash.

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