3-20-1986

A Comment on Salvatore Biasco's, "Exchange Rate Cycles and the International Economy"

Hyman P. Minsky Ph.D.

Preliminary

A Comment on Salvatore Biasco's "Exchange Rate Cycles and the International Economy"

by

Hyman. P. Minsky

Professor of Economics

Washington University, St. Louis
(St. Louis Mo. 63130 U.S.A.)

Prepared for a conference on International Cooperation and Interaction Between Monetary and Trate Policies organized by Centro Di Studi Americani e Istituto Affari Internazionali
Roma 20-21 Marzo 1986

Let us begin with the last paragraph of Professor Biasco's most interesting, stimulationg and important paper. Excerpts from this paragraph read:

"There exists a vast literature about the shortcomings the system of fixed exchange rates has manifested in the past. But the system of fluctuating exchange rates has not shown fewer shortcomings. (This implies that some system of exchange rate stabilization is desired.H.P.M.) The stabilization of exchange rates can be achieved only by general cooperation.....In any case stabilazation must not only mean intervention in the foreign exchange market.....It must also mean the coordination of economic policies. This coordination must conform to rules of the game by which countries with current account surpluses take upon themslves the responsibility of adjustment. This can only be guaranteed by sanctions that can be applied against countries which delay such adjustments."

Professor Biasco's conclusion rests upon a sophisticated argument which shows that in a WORLD with complex international financial linkages, where movements among monetary assets are "easy" and exchange rate changes affect the total return earned on assets, exchange rate cycles of substatial duration result from profit seeking activities of asset holders. These cycles have a profound impact upon the profitability of industries that are affected by international trade. Industrial structure, relative capital asset prices, investment, and the general profitability of business are affected by these cycles. In particular large swings such as occurred between 73 and 79, 79 and 85, and which are now once again taking place can set off "irreversible" (over a meaningful horizon) changes in economic structures and institutional arrangements.

As the micro-economic product, production and investment information that prices and profits carry are especially hard to interpret in a regime characterized by exchange rate cycles, a process of deindustrialization and underinvestment triggered by heightened uncertainty will take place. The obvious response to these problems is the adoption of a regime of fixed, or at least bounded variation, exchange rates.

We need not discuss anew the problems of sterilazation that occurred as the gold standard evolved. This asymetri response of surplus and deficit countries under the regime of fixed exchange rates occurred because clearing was done by using a presumably valuable asset - - - gold or income earning assets dominated in a currency deemed to be strong. To enforce symmetry, which Professor Biasco rightly takes to be a necessary condition for either a fixed or a flexible exchange rate system to work, it is necessary to invent and enforce a worthless clearing asset. This may be an impossible task in a world of national states and sophisticated interrelated financial markets.

Adam Smith's "Invisible Hand" and David Hume's - David Ricardo's" Price Specie Flow Mechanism" are two well nigh ancient conjectures that dominate the intellectual world in which economists live. The Price Specie Flow Mechanism rests upon the validity of the Invisible Hand proposition, for it assumes full employment and a quick and easy transition to new ~~fundamental~~ relative and absolute prices whenever a change in the fundamental real variables or in the "superficial" monetary variables takes place.

Both conjectures depend upon positing the neutrality of money. It is now well known that the Invisble Hand conjecture cannot be shown to be true under the abstract conditions posited by economic theorists (1) and that systems with debts denominated in money (i.e. with a fundamental non-neutrality of money) are likely to be endogenously unstable. (2)

In a capitalist economy with a continuum of assets, stretching from special purpose real capital to the liabilities of banks that function as money, the default free asset -money- is never neutral. This is so because money is almost always (i.e. except when the state is running an overwhelming deficit) created in an exchange for private debts which are entered upon to finance invesment activity and positions in capital assets. The proses of money supply creation and destruction therefor affects the investment - consumption division as well as the ratio of employed to potentially employable resources. The real effects of the exchange rate cycles that Professor Biasco traces out is one way the non-neutrality of money works its way upon the economy.

The price specie flow mechanism tied the determination of exchange rates and price levels to the money supply. Trade imbalances were the initial and sole disequalibrating factor in the exchange market, and the adjustments of price levels resulting from the flow of specie operated to eliminate the trade imbalances. This "scenario" of how international trade and the international flow of financial assets were related dominated discussion at least through the time of Jacob Viner's Studies in the Theory of International Trade.[3]

As Keynes's income flow ideas were integrated into the analysis of the international trade adjustment mechanism, the idea emerged that a country could improve its domestic income and employment (as well as the profits of its domestic businesses) by a positive trade balance. This ability for a country to improve its domestic prosperity by "begger my neighbor" policies depends upon the existence of other countries that are economically and financially secure enough to allow their own prosperity to be sapped. These other countries possessed "fiscal independence", which rested upon their ownership

of offshore assets. The employment and profits they lost through the trade account came back in the form of interest and dividends; albeit the workers and domestic profit earners lost even as ~~the retiers gained~~ rentiers gained.

The analysis of R.S. Sayers in Bank of England Operations, 1890-1914[1] provides a key to understanding the actual rather than the theoretical workings of the international gold standard, of the era just prior to World War 1, which centered around the London money and capital markets. It also provides a framework that enables us to understand ~~the~~ contemporary problems and it provides insights into what is needed to provide a viable international system in today's world. Sayers' framework integrates trade, capital asset incomes, long term foreign investments and flows of short term monetary investments into a balance of payments statement.[2] This framework specifies an initial condition given by the inherited net international investments of any country and then allows for three markets that adjust so that the ex-post balance of payments "balances". This framework implies that if there are "independent" developments that change the desired currency composition of monetary assets there will need to be adjustments in exchange rates, trade balances and long term capital movements.

The framework derived from Sayers breaks the balance of payments into four components, or tiers. The first tier is the current balance on trade and services; merchandise, tourism, banking services, etc.. The second tier, as an ex-post value, is the payments made on account of both principal and interest or dividends because of outstanding international financial contracts. As the existing stock of financial assets commit payments over time, there is also an ex-ante reading for this second tier. For example the debtor nations of Latin America see these tier two payment commitments as a "burden"

stretching forward in time. Each period, so to say, begins with payment commitments due to financial commitments that were entered upon in the past, that are legacies of the past.

The third tier consists of long term capital movements, which Sayers viewed as new placements using the facilities of London's invesment banking community. These new placements can reflect capital development projects and therefor are a demand for funds from the center that is largely independent of the current performance of the borrowing and lending countries.

To Sayers the fourth tier, consisting of movements of money market assets and ultimately specie, was a balancing item that filled the gap that the first three tiers created. However with modern money markets that use technologies that make movements through "space" both instantaneous and cheap and which, since the break down of the Bretton Woods System, are characterized by fluctuating exchange rates the tier four movements are likely to be initiating or sustaining elements in the determination of the balance of payments.

Sayers critique of the Price Specie Flow Mechanism emphasized the significance of tier three in the balance of payments. Long term capital movements, mainly in the form of debt and equity issues placed on the London market, would vary depending on the interest rates. The world of the years just prior to World War 1 was characterized by a large payment flow towards Britain on account of the international indebtedness structure. This was viable because Britain normally ran a deficit on trade account. However the cash flow due to earnings on asset account exceeded the deficit in the trade account. The new foreign investments out of London furnished the rest of the world with the sterling to offset the deficit on tiers 1 and 2. The rest of the world being in debt in sterling, welcomed the short term money market assets they acquired; in

effect the short term capital movements financed part of the long term capital movements.

If the accumulation of short term holdings in London became too large for the portfolio needs of the various offshore banks and central banks they would opt for holding gold. This put pressure on the gold holdings of the Bank of England, and the reaction of the Bank would be to raise the "bank rate". This would slow down the new issues in the London capital market, the sum of the first three tiers would now lower the ~~holdings of~~ holdings of sterling balances. Quite quickly the flow of gold out of the Bank of England would stop and be reversed. The equilibrating mechanism for the balance of payments did not rest upon changes in price levels, money wage rates, or employment levels. The equilibrating pocess normally revolved around the capital and money markets.

Sayers analysed a fixed exchange rate system in which the maximum gain that could be made by being right about the course of the exchange rates was small and in which a movement was sure to halt and be reversed once the gold points were reached. Furthermore in the ancient days prior to World War 1 communication was slow and transactions were costly. We now live in a world of flexible exchange rates where a movement of the exchanges in one direction are not guaranteed to set off processes that stop and reverse the differences. There is no point of reference by which a norm for exchange rates is set.

The combination of flexible exchange rates, instantaneous and cheap communication, and portfolios of money market assets that are being managed in an effort to achieve a

maximum total return means that a movement of the exchange that starts in one direction can build up momentum. This is so because the total return measured in a home currency will include the appreciation that results from being in another, appreciatong currency. Thus if a currency is viewed as appreciating or depreciating, the short term capital movements will both initiate and give momentum to exchange rate movements. This means that the exchange rate cycles that Biasco identifies are a natural consequence of the particular world in which we live.

After Volcker returned from Belgrade and turned the Federal Reserve to the defence of the dollar, a huge international indebtedness denominated in dollars became a feature of the world. This indebtedness was exasperated by the escallation of oil prices and the consequent accumulation of assets by the O.P.E.C. powers. Furthermore there was a sizeable movement of long term funds from the United States. In these circustances political and business cycle developements can lead to a large movement of short term funds to the center; the result will be a large appreciation of the currency of the center and the emergence of a large balance of trade deficit by the center. Quite suddenly the industries of the center will be uncompetetive in world and in its own domestic markets.

By the standards determined by the Price Specie Flow Mechanism the exchange rate movements will be perverse...The deficit in trade will be associated with an appreciating currency. However the world we live in does not conform to the specifications of the Hume-Ricardo model. As Professor Biasco points out the financial and speculative features of the world we live in can have profound employment and profit of industry effects. The policy reactions to the real problems brought about by the exchange rate cycles needs to emphasize the

importance of limiting the gains that can be anticipated from swings in exchange rates. The need is to develop an exchange rate regime in which the appreciations and depreciations of currencies are limited. Swings of the dollar-lira exchange rate such as have occured in the years since the break down of the Bretton Woods system are not conducive to rational investment programs in either country.

Given that the modern transaction technology and the complex financial linkages among countries are here to stay, the fluctuating exchange rate system has to be abandoned. The main policy issue which follows from the analysis of Professor Biasco is to develop an exchange rate regime in which the anticipated returns from holding assets denominated in one currency or the other is not dominated by anticipated movements of exchange rates. The European Snake might be a guide...The dollar, the mark and the Yen need to be joined in a Super Snake.

In this Super Snake the clearing instrument would be a currency unit that the Central Bank need acquire even as it feeds an equivalent amount of reserves into its banking system. The deficit countries need extract reserves equivalent to its clearing losses from the reserve base of its banking system. The worthless clearing unit will enforce the symmetry that Biasco calls for. There will be at best limited gains possible from speculation. The total return available from portfolios will not be dominated by what can be earned by aptly playing the exchanges. The longer term changes in industrial structure will reflect changes in enterprize, they will not be the result of the distoring cycles in exchange rates. International efficiency is not well served when the activities of a casino dominate in determining investment patterns.

1. Bruna Ingrao and Giorgi Israel "General Economiic Equilibrium Theory: A History of Ineffectual Paradigmatic Shifts" Fundamenta Scientiae Vol. VI no. 1 pp. 1-45, 1985 and Vol VI no. 2 pp. 89-125, 1985.

2. John Caskey and Steven Fazzari "Disinflation, Wage Flexibility and Nominal Debt Commitments" Washington University Departmant of Economics, Working Paper # 77, August 1985

3. Jacob Viner, "Studies in the Theory of International Trade" (New York: Harper, 1937)

4. R.S. Sayers, "Bank of England Operations, 1890-1914" (London: P.S. King & Sons, 1936)