Investment and the Global Financial Disorder

By Domingo Cavallo[1]
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The economy is becoming increasingly global as a consequence of declining transportation and communication costs. But institutions and policy decisions continue to be predominantly national.

There has been a relatively high degree of coordination of trade policies through the multilateral, regional and bilateral trade negotiations. But there has been little internationalization of monetary institutions and policies. In previous episodes of globalization there had been international monetary institutions like the Gold Standard, between 1870 and 1930, and the Bretton Woods' Fixed Exchange Rate System, between 1945 and 1971. But that is not the case nowadays. The Global Economy lacks truly international monetary institutions.

Each country is assumed to have a national currency and it is advised to grant independence to its Central Bank to pursue price stability. So, there are almost as many so-called "independent monetary policies" as national economies and the exchange rates fluctuate widely as consequence of those different policies interacting with real cross-border shocks affecting national economies.

There is strong intellectual support for the idea that trade negotiations to establish global trade institutions will strengthen growth potential in all the engaged national economies. But that is not the case for the organization of a truly international monetary system, in spite of the fact that monetary institutions are at least as important as trade institutions to facilitate de adoption of investment decisions in a Global Economy context.

Moreover, I will argue that for the emerging economies, inadequacy of national monetary institutions and absence of an international monetary system capable of providing an anchor for national institutions may be a more important impediment for growth than the existing restrictions to foreign trade.

Investment and Productivity

Growth comes from investment and increased factor productivity. For sure, investment projects will start to be evaluated if there is demand for the goods and services that the increased capacity is able to produce. Relative prices summarize the information on demand of goods and services vis-à-vis actual supply and freer trade will reduce the

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market distortions that otherwise would keep investment opportunities blocked. Eliminating distortions through deregulation and trade liberalization at the national level and engaging in fruitful international trade negotiations is for sure a good strategy for emerging economies.

Deregulation and trade liberalization will open up many investment opportunities that otherwise would continue closed. The old idea that investment opportunities could be created through regulations and limitations to foreign trade as to give some monopoly power to the producers has been proven wrong because this kind of investment does not normally generate strong productivity growth. The competition created by deregulation and trade liberalization reassures that the investment opportunities that are created will call for the most productive technologies and will push up factor productivity.

Investment, Savings and Capital

But once the investment opportunities are created, investment will only be decided and implemented if there is capital available. And capital originates in savings. The first step for an emerging economy to make capital available to investors is to create the institutions that will mobilize domestic savings as to accumulate capital within the national economy. Once foreign savers see that the nationals of a particular country are investing their savings in their economy, they will start considering taking cross border risk and invest in that country. Monetary institutions, including financial and capital markets, are crucial to facilitate or impede channeling of domestic savings to domestic investment opportunities. And, therefore, they are crucial to determine if the country is a recipient or an expeller of cross border capital flows.

Globalization of financial markets and the increasing facilities for cross border capital mobility offer savers of a particular national economy the opportunity of investing abroad whenever their savings are in danger of being eroded by inflation, taxation or any kind of confiscation. Economies with a large experience of such phenomena have grater difficulties to build monetary institutions that will be trusted. The monetary institutions that different countries have adopted relate to their past experience.

Countries with a long history of price stability and responsible monetary policy have fully convertible national fiat currencies managed by independent monetary authorities and floating exchange rates. This is the case of the United States of America, The United Kingdom, Japan, Canada, Australia, Singapore and most European Union nations before the creation of the Euro. The Euro is a currency like the others, except that is not national but regional and has been adopted by 11 nations.

The need for an institutional monetary anchor

Countries that in the past suffered inflationary processes and encountered difficulties to make their national currencies trustable have tried different institutional arrangements.

The participation in an expanded monetary area is one of them and the creation of the Euro is the best example. Countries like Italy, Spain, Greece and Portugal that were still paying high interest rates in long term contracts as a consequence of their history of monetary instability could remove the inflationary expectations from interest rates by joining the Euro and started to get the benefits of a trustable currency and stable monetary institutions.

Eastern European nations will have the possibility of using this mechanism to find an anchor for their still unstable national monies. But so far, Latin American and Asian economies have not found a similar solution ready to be applied. In practice, most of these economies in different opportunities have used the US dollar as an anchor for their domestic monetary regimes.

The use of the dollar as a crucial ingredient of national monetary institutions in emerging economies adopted different forms. On one extreme there is the case of nations that have fully dollarized their economies. This is the case of Panama, El Salvador and Ecuador. Others have let their currencies to compete with the US dollar with the same degree of legal enforceability for both moneys. This is the case of Peru and Uruguay, countries where most of the time deposits and longer term contracts are written in dollars. Then there are countries that have not only made contracts in dollar legally enforceable but in addition have adopted a strong peg through a currency board arrangement for the national currency, which is almost equivalent to full dollarization. And finally, most of the other emerging economies have, at least for some period of time, adopted a weak peg to the US dollar as an anchor for their national currencies.

The opinion of International Financial Institutions and the economic profession has been changing on the merits and pitfalls of these monetary arrangements. Since the Mexican, Asian, Russian and Brazilian crises they have definitively disregarded the weak pegs and have advised the countries to move toward flexible exchange rates and organize independent Central Banks capable of conducting inflation-targeting as national monetary policy.

Consequences of the Argentine crisis

After the crisis in Argentina, the same institutions and economists are starting to disregard strong pegs as well as partial and full dollarization. In my opinion they are making a wrong reading of the Argentinean crisis and the responsibility that the changes in monetary institutions had in making the crisis deeper and more intractable. What they do not realize is how important the dollar is in each one of these emerging economies as an anchor for their monetary institutions and as a protector for the property rights of savers.

Forcing changes in monetary institutions to facilitate desired adjustments in relative prices, particularly in the price of tradable vis-à-vis non-tradable goods, is a very bad idea because it leaves the economy without reassurances of legal protection for savings and

destroys the mechanisms that allow mobilizing domestic savings as to provide financing for domestic investment. In such a situation national economies will only induce outflows of capital and will never get capital inflows.

Monetary institutions and monetary policy should be used only to reassure price stability and create confidence on the protection of the property rights of savers and should not be manipulated to change relative prices of the economy. The appropriated instruments for affecting relative prices are trade institutions and policy, indirect taxes and regulations.

The case of Argentina 2002 shows clearly that the attempt to set the "right prices" by changing the monetary institutions of the 90's have aggravated the recession and destroyed the "property rights" of savers[2]. No emerging economy should be advised to follow that strategy if it wants to preserve the possibility of renewing growth through investment and productivity increase. Argentina itself will have to work hard and soon to rebuild its monetary institutions as to reassure savers that their financial wealth will be protected from arbitrary changes in the rules of the game. That will very likely rule out discretionary monetary policy for a long period of time.

[2] See Cavallo, Domingo, Argentina 2002: the attempt to set the "right prices" that destroyed "property rights", available in website www.cavallo.com.ar.