BOOK REVIEWS

In Defense of Free Capital Markets: The Case Against a New International Financial Architecture
David F. DeRosa
Princeton: Bloomberg Press, 2001, 201 pp.

Foreign exchange crises convulsed much of Europe in 1992 and 1993, Mexico in 1994, much of Asia in 1997, and Russia and Brazil in 1998. Long-Term Capital Management, a major U.S. investment firm, the general partners of which included two financial economists who are Nobel laureates, collapsed in 1998. And Japan's economy has now been in the doldrums for more than a decade.

Those financial crises, in turn, led to numerous proposals for "a new international financial architecture" including proposals for controls on international capital flows, a worldwide tax on foreign exchange transactions, target bands on exchange rates, a requirement that private lenders participate financially in the restructuring of any new sovereign debt owed to them, and a new tax-financed international credit insurance corporation.

Fortunately, we now have a readable book describing those financial crises, the lessons we should have learned from them, and an evaluation of the major proposals for a new international financial architecture. David DeRosa has the right credentials for this task—a professional foreign exchange trader, an adjunct professor of finance at the Yale School of Management, and a regular columnist for Bloomberg News. Most important, for those who are mystified by financial issues, DeRosa is a disciplined analyst and a fine writer.

The general thesis of this book is that, " . . . the concept of financial contagion . . . is dubious at best as a cause of financial turmoil. (As a rule, a financial crisis) . . . can be explained by looking at the domestic policies that ministries of finance and central banks have laid out for their own countries." This is a valuable perspective, because it focuses attention on the conditions that were common to the countries that experienced a financial crisis. Most important among those conditions, all of the countries that experienced a foreign exchange crisis were trying to maintain a pegged exchange rate. In addition, beginning with the Mexican crisis, the other common conditions were a large volume of short-term debt de-

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nominated in some reserve currency (such as the U.S. dollar) and a substantial government role in the allocation of credit.

Although other analysts have also identified those same conditions, DeRosa's distinctive contribution is to describe the important role of the *carry trade* in triggering an exchange rate crisis and overwhelming the official efforts to avoid a devaluation. This involves a number of trading strategies that go long the domestic currency and short the reserve currency, solely to capture the interest rate differential between the two currencies; in effect, those trades are a bet that the pegged exchange rate will be maintained. Although that differential is usually small, the potential profits are huge if these investments are hedged *and* the exchange rate is maintained. The potential losses, of course, are also huge if the exchange rate is devalued. That is what leads traders to herd behavior in the attempt to be the first ones to liquidate their positions if there are any signals that the exchange rate will be devalued.

In the end, however, DeRosa's effort to counter the contagion perspective is not wholly successful, in part because the sequence of crises in Europe in 1992 and in Asia in 1997 do not appear to be random events, in part because losses to the carry trade in one country probably increase concern about similar losses in other vulnerable countries. That is unfortunate, because the debate on the role of the International Monetary Fund (IMF) is primarily about the relative importance of the contagion effect and the moral hazard effect, with defenders of the IMF emphasizing the contagion effect and critics of the IMF emphasizing the moral hazard effect. One might hope that, 17 years after the Mexican crisis, we would have more than anecdotes and perspectives on the relative magnitude of those two effects.

This book also has a good summary of the reasons for the continued stalemate in Japan. This chapter, however, does not quite fit the rest of the book, because the yen has long been a floating currency and Japan is a big net exporter of capital. DeRosa's special insight in this chapter is that the near zero interest rate in Japan is not sufficient evidence of a "liquidity trap," and he concludes, as do most western observers, that Japan would now be well served by Bank of Japan purchases of government debt to increase the money supply. On two developments in the 1980s, I have a somewhat different interpretation than that by DeRosa: My judgment is that the substantial increase in the foreign exchange value of the dollar in the early 1980s was primarily due to the investment provisions of the 1981 U.S. tax legislation, not, as is the conventional explanation, the result of the combination of a loose fiscal policy and a tight monetary policy. And the end of the 1980s boom in both Japan and the United States, I contend, was primarily due to the tighter bank capital standards required by the Basel Accord.

DeRosa concludes, I believe correctly, by rejecting all of the proposals for a new international financial architecture. He recognizes that countries have many economic problems other than a faulty exchange rate

system, but the primary lesson of this book is that, "The '90s, far from being an indictment of the international financial system, are a striking reminder of how potentially destructive fixed exchange rate regimes can be. Equally striking is the fact that once broken fixed exchange rate systems are replaced with floating regimes, no further disruptions occurred."

For a broad audience, this book is the best introduction to this history and these issues, although probably not the final word.

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