DeRosa Research and Trading, Inc.
495 White Oak Shade Road
New Canaan, CT 06840
Tele (203) 801-4340 Fax (203) 801-4342
derosa@derosa-research.com

Testimony of David F. DeRosa, Ph.D
Before the House Subcommittee on
Domestic and International Monetary Policy,
Trade and Technology.

Opening Trade in Financial Services—
as well as The Chile and Singapore Example

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Good afternoon, Mr. Chairman and members of the Subcommittee. I am David DeRosa, President of DeRosa Research and Trading, Inc. and the Frederick Frank Adjunct Professor of Finance at the Yale School of Management. My testimony will concern my position on capital controls.

In the middle 1990s and continuing up to the present time a great many emerging markets nations experienced cataclysmic financial crises. Many of these same nations had previously been identified as "miracle" growth economies. Examples of such crises include but are not limited to Mexico (1994), Thailand, Indonesia, and Malaysia (1997), South Korea (1997-1998), Russia (1998), Brazil (1998), Turkey (2001) and Argentina (2002).

The aforementioned crises devastated these counties. Much economic suffering ensued - inflation, unemployment, and business bankruptcies were widespread. stock and bond markets plunged, and in all cases national currencies depreciated severely and the foreign exchange regimes that governed exchange rates were abandoned.

The reaction to this series of crises has been largely to blame the international capital markets and the foreign exchange market. Some say that the afflicted countries were victims of capricious international capital flows. Hence we are here today to discuss whether the trade agreements that our nation is contemplating ought to contain provisions allowing our trading partners to invoke capital controls.

I studied economics and finance at the University of Chicago where I received both a bachelor's and a doctorate. In the subsequent years I have never found a contradiction to the fundamental doctrine of the "Chicago School of Economics" that free markets make for the best markets. Capital markets are no exception.

Over the two dozen years since I left Chicago I have held a wide variety of markets-related positions. For a good part of the 1990s I was a currency trader at a major money-center bank and later at a hedge fund. At the present time I am a member of the board of directors of two large and successful hedge funds.

When I combine my academic training in economics with my "real world" experience in markets I arrive at a very different understanding of why the above-mentioned emerging markets crises occurred. I don't believe the fault comes from the markets, or, as it is fashionable to say, the "international financial architecture." The following conclusions are supported in my recent book entitled <u>In Defense of Free Capital Markets: The Case Against A New International Financial Architecture</u> (2001, Bloomberg Press):

- All of the above-mentioned crises, except one (Malaysia), took place in economies that had some form of fixed exchange rates. In fact the climax of each of these crises was when the disintegration of the fixed exchange rate regimes transpired.

- Each crisis was marked by a sharp outflow of capital prior to the moment the fixed exchange rate regime was scrapped. Once the peg was abandoned the local currency depreciated massively, in some cases by more than 70 percent.

- In each case the government of the afflicted country replaced the fixed exchange rate regime with a floating exchange rate regime. Importantly, no further currency crises occurred after adopting floating exchange rates.

- That all of these countries had accumulated massive amounts of private and public debt denominated in dollars aggravated the crises. As the exchange rates depreciated the local currency values of these debts were magnified greatly.

- Preceding the crises, an enormous amount of foreign capital flooded into the countries, sometimes buying local securities, sometimes as direct investment. Interestingly it also came in the form of leveraged transactions that sought to capitalize on higher interest rates in the local currency under the security of the fixed exchange rate regimes.

- These trades, known as "carry trades," would never have been created had it not been for the fixed exchange rate regimes. In fact, a great deal of the investment inflows in these countries was nothing more than an attempt to capture high local interest rates in the "safe" environment of fixed exchange rates. Investors were not investing in these countries so much as they were investing in the fixed exchange rate regime.

- History shows they are crises-prone. The problems in emerging markets are not caused by capital of a capricious nature but rather by the inherent instability of fixed exchange rate regimes.

- The reason why currencies depreciate so violently when fixed exchange rate regimes are abandoned is that domestic dollar borrowers, as well as foreign investors, rush to hedge their exposure to the doomed local currency.

- Governments in crisis countries often make things worse - sometimes considerably worse - by enacting bad policy responses. Thailand, Indonesia, Russia, Brazil, and Argentina stand out as especially poor examples in responding to their crises.

- Emerging markets nations can avoid these crises in the first place by not using unsustainable fixed exchange rates.

- Capital controls are neither desirable nor effective in avoiding crises or responding to crises.

    - A popular myth is that Malaysia found a "kinder and gentler way" to deal with its crises by imposing capital controls. This is bogus. Malaysia imposed its capital controls a full 14 months after the crisis erupted - a classic case of locking the barn door after the horse had bolted.

    - Moreover, Malaysia imposed the controls concurrently with fixing its currency, the ringgit, at 3.8 to the dollar, where it remains today. Malaysia then sat back and enjoyed what amounted to a regional devaluation of its currency because all of the other Asian nations, including Japan, saw large revaluations of their currencies. Malaysia pulled a "fast one."

    - Parenthetically, Malaysia had a floating exchange rate, more or less, before the crisis. It also was notorious for imposing capital controls. Fear of new capital controls explains why Malaysians and foreigners rushed to cover exposures to the ringgit when the Thai baht exploded on July 2, 1997.

My conclusion based on my observations and analysis is that financial crises never appear as random visitors - they never show up uninvited. Crises are manufactured from bad and unsustainable policies, fixed exchange regimes being at the top of the list, and aggravated by local policy response blunders. Careful analysis shows capital controls are neither effective nor desirable.

Thank you Mr. Chairman and thank you members of the Subcommittee.