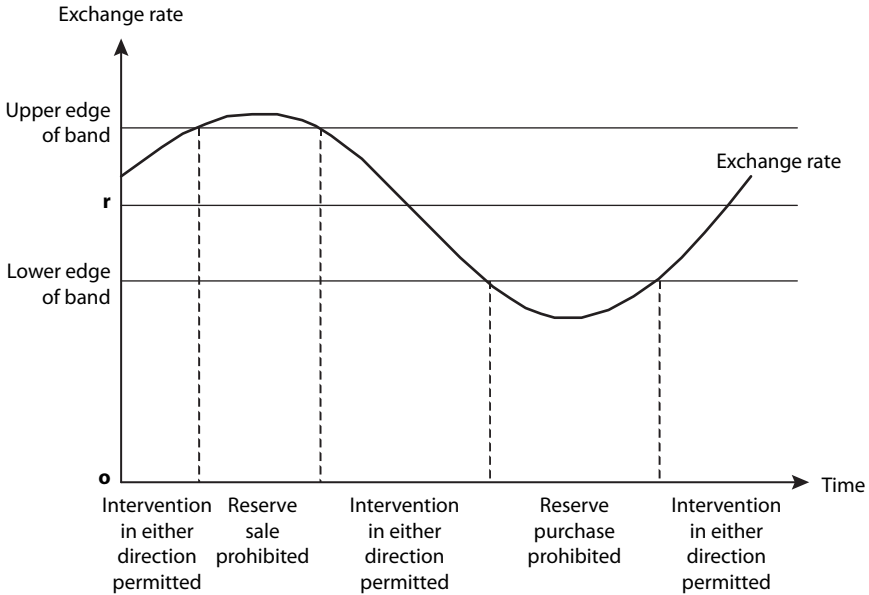

Three Alternative Variants of the Reference Rate Proposal

The reference rate proposal may take three slightly different forms. The simplest version involves no band but simply an obligation to refrain from intervention that would push the exchange rate away from the reference rate. One problem that some may perceive in such a rule is that it seems to commit the authorities to a belief that they can identify the “right rate.” They may feel more comfortable with a rule that requires them only to name a band within which the equilibrium rate lies rather than a particular rate. The difference is largely psychological since any band has a center and there is in any case no compulsion to defend any particular rate, but psychological considerations may matter. And if there is a band, it may be a band within which intervention in either direction is permitted, or a band within which no intervention is allowed. Hence there are three versions of the reference rate proposal.

The Three Versions of the Proposal

The simplest (“canonical”) version of the reference rate proposal prohibits a central bank from intervening to buy foreign exchange, and thus weaken the currency further, when its currency is weaker than the specified reference rate. Similarly, it would be prohibited from intervening to sell foreign exchange for domestic currency, so as to strengthen the latter, when its currency is stronger than its reference rate. Any intervention should thus have the effect of driving the exchange rate in the direction of the reference rate (though there is never any obligation to have any intervention at all). The rules are illustrated in figure 2.1 in chapter 2. Similarly, any

Figure 4.1 The original version of the reference rate proposal



other policies that may be specifically directed to influencing the exchange rate should tend to drive it toward its reference rate.

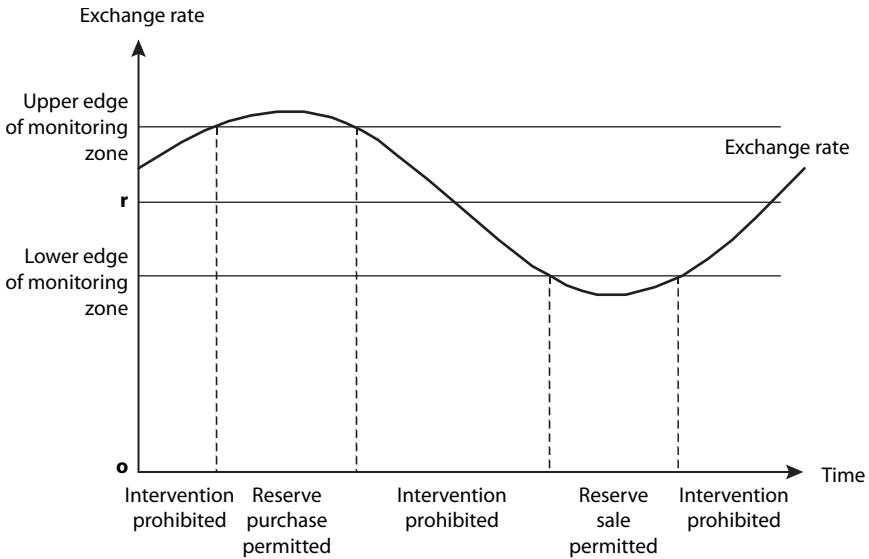
The second version of the reference rate proposal is that envisaged by Ethier and Bloomfield (1975) in their pioneering paper introducing the proposal. It is referred to subsequently as the “original version.” This version would allow intervention in either direction within the band. The obligation of pushing the rate toward the reference rate would start to apply only once the deviation of the market rate from its reference rate exceeded a certain critical threshold. See figure 4.1 for a diagrammatic exposition.

The other variant of the proposal envisages a band within which no intervention at all would be permitted. Central banks would be allowed to intervene to push the rate toward the reference rate only once its deviation from the reference rate exceeded a critical threshold. The exchange rate would be obliged to float freely within a zone around the reference rate. This proposal was first advanced by the Tarapore Committee (1997) on Indian capital account convertibility. It called the band within which no intervention would be permitted a “monitoring zone.” This variant is illustrated in figure 4.2.

Evaluating the Three Proposals

What are the pros and cons of these three variants? The big pro of the canonical version is its simplicity. It is the easiest variant to describe. The

Figure 4.2 A monitoring zone



disadvantage is that either of the alternatives might be more likely to appeal to certain groups with strong views, in addition to those with a psychological aversion to naming a specific rate rather than a band.

Those who are reluctant floaters would be more likely to see virtue in the proposal to allow intervention in either direction unless the market rate drifted sufficiently far from the reference rate to exceed a critical threshold (the “original version”). It would even be possible to reconcile this version with a bilateral peg, if the peg were adjusted periodically when the other currencies in the pegging country’s effective exchange rate had appreciated or depreciated significantly against the peg currency. Provided these adjustments were made promptly and in small steps, they need not be disruptive to the market. Such a solution might offer a compromise system in which countries would be able to maintain their traditional policy of pegging but with an element of international discipline added. It might be particularly attractive to a country that trusted its own ability to select a parity more than it trusted the judgment of the IMF, although the Fund would still have the power to constrain a country’s choice.

Conversely, the monitoring zone variant is closer to floating. It needs a strong presumption that the market is generating a misalignment to justify authorizing a country to depart from a free float. Those with little confidence in the ability to make estimates of equilibrium exchange rates will presumably feel more comfortable with this variant.

Would it be possible to allow some countries to adopt one variant of the proposal and others to adopt a different variant? If the monitoring zone

variant were to be adopted at the systemic level, it would preclude any country from adopting either of the other variants. Conversely, if the original version were to be adopted at the systemic level, then those countries that wished to would be free to constrain themselves more tightly, by adopting either the canonical variant or the monitoring zone variant. Were the canonical version to be adopted at the systemic level, it would rule out any countries adopting the original version, but it would allow those countries that so wished to adopt the monitoring zone version.

My sympathies are with monitoring zones, or failing that with the canonical version, rather than the original variant, because I believe that exchange rate changes play a useful adjustment role. My quarrel with floating is merely that it is prone to generate large misalignments. Nevertheless, if adoption of the original variant at the systemic level were the price of reaching agreement, I would not hesitate to pay it. The important issues are the introduction of an agreed international discipline on large misalignments and (a topic discussed later) the public identification of a set of estimated equilibrium exchange rates, and these could be achieved by any of the variants, including the original one. This system would in no way constrain countries that felt comfortable with a policy closer to floating, since it would merely be permissive.