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The BBC Regime

Advantages of BBCs

As was indicated above, "BBC" stands for band, basket, crawl. For the group of emerging-market economies that are the focus of this book, a BBC regime offers several advantages.

For one thing, when an emerging-market economy has a diversified pattern of trade and debt-servicing arrangements with the major industrial countries, a basket peg offers some cushion against (unwanted) third-party exchange rate movements, thereby producing greater stability in the effective exchange rate. In this regard, it has been estimated (Escude 2001) that if Argentina had been pegged since July 1995 to a 50:50 dollar-euro basket rather than exclusively to the US dollar, the peso would have been subject to a real depreciation of 2 percent (to March 2001) instead of a real appreciation of 22 percent.[1]

In a similar vein, officials from Japan and East Asian emerging-market economies have often pointed to the (single) currency peg to the US

1. Escude (2001) shows that the 22 percent real appreciation of the Argentine peso during this period reflected a 14.6 percent real depreciation against the dollar zone (accounting for 14.7 percent of Argentina's noncommodity exports), a 40.8 percent real appreciation against the euro zone (22.8 percent of noncommodity exports), a 55.8 percent real appreciation against the Brazilian real (30.2 percent of noncommodity exports), and a 5.4 percent real appreciation with respect to 26 other trading partners (32.3 percent of noncommodity exports). There would, of course, be other periods where a basket peg could produce a real appreciation, but the point is that the basket should produce more stability in the effective exchange rate.

dollar, along with the dollar's large nominal appreciation vis-à-vis both the yen and the euro (equivalent) in the 2-year run-up to the Asian crisis, as having increased significantly their crisis vulnerability.[2] Accordingly, a more and more popular element in the discussions of a currency regime for postcrisis Asia is a basket peg, with a higher weight for the Japanese yen than in the past.[3]

A second advantage of a BBC regime is that the crawl reduces the chance that the real exchange rate will become misaligned because the home country is running a higher inflation rate than its competitors. By making the change in the nominal exchange rate the outcome of a rule-based process, one can in principle come closer to "depoliticizing" the exchange rate decision. The crawl itself can be either backward looking (to offset recent inflation differentials) or forward looking (say, based on a declining forecast inflation rate to steer inflation down over time).[4]

Advantage number three of a BBC regime is that a wide band (say, 15 percent on either side of parity) provides some exchange rate flexibility to deal with asymmetric shocks (including those generated by shifts in private capital flows) and to accommodate a certain degree of independence in the conduct of monetary policy. In addition, a wide band is more forgiving (than the narrow band associated with traditional adjustable peg regimes) of the fact that estimates of the equilibrium exchange rate for emerging-market economies have varied widely across different studies and thus are likely to be subject to a considerable margin of uncertainty.[5]

Disadvantages of BBCs

Given the advantages just described, why am I not more enthusiastic about proposing the BBC as the preferred regime choice for emerging-market economies heavily involved with private capital markets? Although a BBC regime is more flexible than an adjustable peg regime, it is still not flexible enough to handle the large and abrupt shifts in investor sentiment and in private capital flows that characterize today's global economy. When the big shocks come—be they internal or external, policy induced or beyond the control of the local authorities—even a 15 percent band is not likely to be accommodating enough to handle them. In that case, the

2. From January 1995 to April 1997, the dollar appreciated (in nominal terms) by 25 percent against the yen and by 17 percent against the synthetic euro.

3. E.g., see Ogawa and Ito (2000) and Williamson (2001b).

4. See Williamson (2000).

5. Edwards and Savastano (1999) show how wide-ranging have been estimates of equilibrium real exchange rates for emerging-market economies.

band will likely be widened farther and farther, chasing the movement in the actual exchange rate--until the band is ultimately abandoned altogether in favor of a float. We saw recent versions of that scenario in the currency crises of Indonesia, Russia, and Turkey.

Another serious problem with a BBC regime is that its ability to induce stabilizing speculation and/or to furnish a good nominal anchor for monetary policy is highly suspect. Williamson (2000) has argued that the expectation by market participants that the authorities would intervene to defend the band at the margin would produce stabilizing speculation. In an important theoretical paper on target zones, Krugman (1991) has indeed shown that if such expectations are firmly held, then the behavior of the exchange rate will benefit from such a "honeymoon effect."

Most of the evidence we have on this matter comes from the exchange rate mechanism (ERM) experience with an adjustable peg regime, and it is not favorable to the existence of such stabilizing expectations. As has been emphasized by Clarida (1999), the empirical evidence indicates that interest differentials widened—not narrowed—as exchange rates within the ERM got close to the edge of the band. Likewise, other (theoretical) predictions of a well-behaved target zone model have not in general been supported by the data.[6] If the ERM—with all its structure and with all that was at stake politically on the way to Economic and Monetary Union—could not produce stabilizing speculation, what likelihood is there that such speculation would be forthcoming in a looser target zone arrangement with much less at stake politically? And if, in an effort to reduce its vulnerability to large shifts in capital flows, a BBC regime had "soft margins" or "monitoring zones" that removed the obligation of the authorities to defend the edges of the zones, the likelihood of the scheme attracting stabilizing speculation seems even more remote.[7] I just do not believe one can get the kind of credibility the BBC seeks "on the cheap" by a very loose conditional agreement to defend the zone.

Along the same line of argument, it is difficult to see how a BBC regime would provide much of an anti-inflationary anchor for monetary policy. In this regard, Levy-Yeyati and Sturzenegger (2000) find that it is intermediate (de facto) currency regimes that have historically (at least during the 1974-99 period) yielded the highest average inflation rates and rates of monetary expansion. In a BBC scheme, a nominal anchor

6. See Svensson (1992) and Goldstein (1995).

7. A related weakness of a BBC regime, at least relative to both a simple peg and a plain vanilla float, is that it will be less transparent. As argued by Frankel, Fajnzylber, and Serven (2000), with a basket, a band, and a crawl, the public has no way of verifying quickly, by observing the exchange rate, whether the monetary authorities running the currency regime are doing what they claim to be doing. In a set of statistical exercises, they find that higher bandwith, multiple-currency baskets, and frequent parity alignments all make more difficult the "verifiability" of an intermediate currency regime.

would have to come from some other mechanism (outside the currency regime), and the proponents of the BBC have not said much about what this (replacement) nominal anchor would be.

Some have maintained that a BBC regime might be the ideal postcrisis currency regime for Asian emerging-market economies.[8] I doubt it.

Although a basket with a higher weight for the Japanese yen would offer dividends (especially in view of the weakness of the yen), most of the Asian crisis countries have not made enough progress on restructuring their financial systems to make defense of a publicly announced exchange rate zone credible. With the former crisis countries still having a considerable way to go to put their financial and corporate sectors on a firm footing, with the region's exports reeling (in 2001) under the influence of a G-3 slowdown and a crash in electronics, and with net flows of external finance to the crisis countries at a depressed level, it is difficult to envision the crisis countries raising interest rates aggressively to defend an exchange rate target (if the need arose to meet a large negative shock).

Nor are the swap arrangements that would come into force under the recent Chiang Mai agreement large enough at this stage to deter a speculative attack. Recall that Hong Kong had $60-$100 billion in reserves, a pledge of support from Beijing, and a strong banking system when it was attacked in 1998, and that it only managed to sustain the peg by a huge, unprecedented government intervention in the stock market. Recall also that it took Europe about 50 years of preparation to make Economic and Monetary Union a reality. For now, then, it is better to continue the recent postcrisis exchange rate policy (outside of Malaysia) of managed floating with more flexibility than before the Asian crisis.[9] Any move now to a common Asian currency would be premature.

To sum up, although the BBC regime is superior to an adjustable peg for emerging-market economies heavily involved with private capital markets, neither its crisis resiliency nor its anchoring properties are good enough to meet the test.

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8. E.g., see Williamson (2001a), Ogawa and Ito (2000), and Ito (2001). Bergsten (2001) is also more optimistic than I am that Asian regional intervention and support arrangements could sustain a target zone or BBC regime there.

9. See Hernandez and Montiel (2001); they also dispute McKinnon's (2000) claim that the Asian crisis countries have resumed a de facto, high-frequency, dollar-pegging policy.