

# **The Choice of Exchange Rate Regime: The Relevance of International Experience to China's Decision**

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## **Introduction**

Whether a country should choose a fixed or flexible exchange rate, or some intermediate regime, is one of the oldest policy questions in economics. It is also one of the most important. Many countries have encountered crises that interrupted their growth because they made a bad choice. Others have never got growth going because of misguided decisions. Obviously this is not to say that exchange rate policy is the only thing that matters, but it is to claim that a flawed exchange rate policy can bring the rest to naught.

How should one evaluate China's current policy, of pegging its exchange rate in terms of the US dollar? This has not, at least as yet, led to a crisis that interrupted growth, and it certainly has not prevented an impressive growth performance. This does not mean that China's current policies deserve to be perpetuated, but it does imply that any change needs to be evaluated carefully to make sure that it will not risk undermining China's success.

I start by describing what I see as the two most important lessons of international experience with exchange rate regimes in the period since World War II. I then proceed to lay out the conditions that are necessary in order for a fixed exchange rate regime to make sense. Since some of those conditions are clearly not satisfied by China, I describe some intermediate regimes that might be desirable where a fixed rate is inappropriate. Finally I turn to discuss what the analysis implies as regards contemporary China.

## **The Crisis Problem**

The postwar period has been punctuated by foreign exchange crises. In my own country, Britain, we used to have a sterling crisis more or less every other year (usually in odd-numbered years) until the late 1960s, after the pound was devalued. These crises regularly provoked a set of deflationary measures that interrupted growth. Other industrial countries often had similar crises (though with less regularity), which was a major factor leading to abandonment of the Bretton Woods system in 1973. The majority of these crises were associated with an attempt to prevent a currency being devalued, but in the late 1960s there were also speculative runs into several currencies, like the Deutsche mark and Swiss franc, that were eventually either revalued or allowed to float up.

The European Monetary System (EMS) did not have crises of comparable severity in its early years, when parity changes were undertaken promptly and were therefore rather small. However, in 1987 a decision was made to “harden” the EMS—i.e., to avoid further parity changes. This allowed large disequilibria to build up. After German reunification these could no longer be contained, and the EMS suffered a series of major crises leading to the withdrawal of Britain and Italy in 1992 and the widening of the margins from  $\pm 2\frac{1}{4}$  percent to  $\pm 15$  percent in 1993.

The 1990s witnessed a series of devastating crises in emerging markets, many of them clearly the consequence of an attempt to defend an exchange rate. The first of these was in Mexico at the end of 1994 and led to a decline of almost 7 percent in GDP in Mexico the following year (as opposed to an average of 3 percent growth in the preceding years). This was followed by the outbreak of the East Asian crisis in July 1997. The Thai crisis that initiated the regional crisis was clearly a consequence of defending an exchange rate that had become overvalued, although the exchange rate was not central in some of the subsequent crises (notably in Indonesia and Malaysia) that were a consequence of contagion rather than indigenous policy mismanagement. Thai GDP fell by 11 percent in 1998, while that in Indonesia fell even more (by 14 percent) and that in Malaysia by almost as much (nearly 8 percent), as against a precrisis growth rate averaging 8 percent or more in all three countries. The Korean crisis in December 1997, which was also aggravated by the use of reserves to defend an almost-fixed exchange rate, led to a fall in GDP of almost 7 percent in 1998 (i.e., 15 percent below trend). Even Hong Kong, though not forced to devalue, paid a steep price in terms of a 5 percent recession (10 percent below trend) for its defense of a fixed exchange rate.

The crises did not end in 1997. Russia was forced to abandon its attempt to use a fixed exchange rate to stabilize the price level in August 1998. Panic spread to Brazil, which held off devaluation for a few months (till after its elections) with the aid of an IMF program but was forced to devalue anyway in January 1999. In this case growth resumed rather rapidly, partly because the government had shielded the Brazilian private sector from financial losses. (However, the consequent increase in public debt of roughly 6 percent of GDP made the country more vulnerable when it came under renewed financial pressure when the markets recognized that a leftist was likely to be elected president in 2002.) But the effect of the Brazilian devaluation on its neighbors was devastating, and before long Ecuador, Argentina, and Uruguay had all confronted twin foreign-exchange and banking crises, in each case with devastating effects on growth.

It is therefore a historical fact that attempts to defend a fixed (or almost fixed) exchange rate against market pressures have initiated financial crises that have often proved extremely costly. The next question we need to ask is exactly why that should be. It is natural to answer that question separately for cases of downward market pressure on the currency and cases of upward market pressure. Consider first the more common case of downward market pressure leading to a devaluation.

Why should that be deflationary? There are in fact offsetting forces:

- Home-produced goods are now more competitive, both in the domestic market against imports and in foreign markets where exports gain a competitive edge. This is expansionary.

- On the other hand, devaluation causes an increase in the domestic price level and this reduces the real value of the money supply, which is contractionary.
- Moreover, if the country has taken loans denominated in a foreign currency, then devaluation will increase the value of debts in terms of domestic currency, and unless the loans were contracted by an agent with export income there will be no corresponding increase in the ability to service debt. This too will be contractionary.
- There may also be indirect contractionary effects of this, in reducing the value of stocks (equities) and, if the solvency of the financial sector is threatened, deterring domestic lending.
- Finally, and perhaps most important, the country will have to contract foreign loans (in order to cover any current account deficit that remains and in order to roll over maturing loans) in an environment where foreign confidence in the worth of the government's word has just been undermined by a devaluation undertaken in defiance of its previous commitments. This may require some combination of high interest rates, which will again be contractionary, and currency overshooting (thus amplifying the preceding negative factors, though not the first positive factor to the extent that exporters realize that the overshooting is temporary).

So there *can* be circumstances in which devaluation has a rapid positive impact: important competitiveness effects, no foreign-currency loans or a government decision to shield the private sector from losses, and little need to contract additional foreign debt (circumstances that were present, for example, in Britain in 1992 or Brazil in 1999). But the usual situation is the reverse. The competitive gains take time to produce their results, while the negative effects kick in immediately, especially where there are large foreign-currency debts. This was the case, for example, in East Asia in 1997.

The result is recession, sometimes severe. Given that this is the cost of devaluation, one may ask why any government should choose to devalue. The answer is that it may be even more costly *not* to devalue, because it is impossible to combine satisfactory domestic economic performance (full employment, high growth) with a balance of payments deficit that the rest of the world is prepared to finance. Restoring that compatibility requires improved competitiveness, which is most quickly achieved (even if at the cost of a recession) through devaluation. Admittedly a process of internal price deflation is in principle another way of accomplishing that, but this is bound to be a very long drawn-out process that may require years of high unemployment. The market knows this, and is therefore skeptical of government promises that it will never devalue. Governments nonetheless regularly make such promises, in the hope that they will bolster confidence and thus reduce the cost of maintaining the exchange rate peg. They typically see this as necessary when the first signs of overvaluation appear, when they still hope that they can avoid the bitter medicine of devaluation with its threat of recession and often also disrupting a program for stabilizing prices that relied on use of a fixed exchange rate as the nominal anchor. And for a time it may well work. Even though the market knows that the government will not stand by its promise if it becomes excessively costly to do so, it also knows that the government will bear some costs if it devalues, and will therefore resist doing so as long as it has an option. That makes it rational to refrain

from speculating against the currency unless others are doing so too. Once speculation starts, however, no one wants to risk being left holding a currency that is a candidate for devaluation, so a run out of the currency quickly develops.

Economists who recommend against devaluation under any circumstances normally advocate institutional measures, such as a currency board (like that in Hong Kong), that will compel a country to avoid devaluation and rely instead on internal price deflation to adjust a payments deficit. The lesson of the Argentine crisis is that even such a rigid institutional constraint will be broken if the costs of standing by it become too great.

So much for the costs of defending an overvalued exchange rate and the devaluation that follows the abandonment of such attempts. Are there symmetrical costs that oblige a country with an undervalued rate to revalue, and that are realized when a country finally gives in and revalues?

There are costs, but they are quite different. They consist of inflationary pressures and the costs of sterilization. It was primarily the fear of growing inflationary pressures that prompted countries like Germany and Switzerland to revalue in the late 1960s. At the time there was considerable skepticism in other countries as to whether these countries were making a wise choice in giving such priority to anti-inflation policy, but they were amply rewarded for this in the 1970s when other countries discovered the high price of controlling an inflation that had by then become inertial. In order to prevent reserve inflows expanding the money supply and igniting inflation, some countries have spent considerable sums on sterilizing reserve inflows: for example, Chile spent approaching 1 percent of GDP each year in the mid-1990s in this way. And if a country does revalue, then it pays a capital gain to those who speculated in favor of its currency prior to the revaluation. If it delays the revaluation until there is little market pressure stemming from additional inflows, this is in fact liable to be an even more significant cost, given that the market inflows normally ease off only after most of the money that can legally enter has already done so. And, of course, the country suffers a capital loss in terms of its domestic currency on the reserve holdings of its central bank.

These costs are important, but they are not comparable with the costs of overvaluation. Hence my first major lesson from the experience of the postwar years: *Avoid defending an overvalued exchange rate.*

The main response to growing recognition of the importance of this lesson has been the resort to floating exchange rates. This does not resolve all problems, for floating rates are at least as liable as fixed rates to become misaligned, and they will not avoid all types of financial crisis. But floating exchange rates combined with inflation targeting do provide a formula which seems to provide a viable nominal anchor while avoiding the danger that a country will find itself defending an overvalued exchange rate, with all the potential that has to drag a country into a crisis that will disrupt its growth (Truman 2003). Moreover, they provide a more secure formula for that than maintaining a fixed rate that is undervalued, for an undervalued rate will generate inflationary pressures and it is not always easy to stop an ongoing inflation at just the point when the undervaluation has been corrected. (Inflationary processes develop their own momentum, as the world learned the hard way in the 1970s.) And of course what matters from the standpoint of macroeconomic management is the *real effective exchange rate* (i.e., the average inflation-adjusted exchange rate against all trading partners). A rate that is fixed in terms

of some other currency can easily become overvalued if the currency to which it is pegged floats up in terms of other currencies with which the pegging country trades, leading to an appreciation of the real effective rate. (Argentina again provides the prime example.)

Note that I am *not* saying that the only way of avoiding the danger of ending up defending an overvalued rate is a “clean” float. In fact, I believe it is possible to design a “target zone” regime that will avoid this danger under almost all conditions, and I certainly believe that managed floating is consistent with avoiding that danger. All I am saying is that there is a major lesson that we need to draw from the historical record, and that the main response has in fact taken the form of floating rates.

## **The Growth Issue**

Most economists would, I believe, concur with the first lesson of the historical record that I suggest above. I am not equally confident that most would agree with my second lesson, but I nonetheless believe it to be important.

In fact, many economists would question whether there is a link between the exchange rate and an economy’s growth potential. Most would accept that there is a short-run link to realized growth in that a more competitive exchange rate will increase demand for exports and import substitutes and will therefore boost aggregate demand, but they would dismiss that as a short-run effect that will not impact the potential (or supply-side) growth rate that is constraining in the longer term. This they think of as determined by the growth of factor supplies and productivity, as postulated most famously by the neoclassical growth model (Solow 1956), and they see little reason to postulate an impact of the exchange rate on either. Even endogenous growth theory has not given the exchange rate a role among the factors that determine an economy’s supply-side rate of growth.

The most conspicuous recent exception to this tradition consists of the Deutsche Bank economists Michael Dooley, David Folkerts-Landau, and Peter Garber. In a series of papers (e.g., Dooley, Folkerts-Landau, and Garber 2003), they have argued that Asia consists of a “trade account” region that maintains a relatively fixed, undervalued exchange rate against the US dollar with a view to promoting manufactured exports and thereby growth. Their analysis contains no acknowledgment of the idea that growth might be constrained by a lack of supply capacity rather than by a shortage of demand. Rather, an undervalued exchange rate increases the demand for exports and extra export demand prompts extra production, i.e. faster growth. Since their main policy objective is to grow, these countries are quite prepared to finance the resulting current account deficit of the United States by accumulating dollars, even if they foresee that these dollars are likely to depreciate relative to other assets like the euro.

Ironically, given that Deutsche Bank is still a German bank and Germans have traditionally been so skeptical of Keynesian economics, the other economists who share a similar view of the rationality of running current account surpluses in order to grow are the self-styled Keynesians whose intellectual home is Cambridge (England). They also believe that the key to faster growth is increased demand since there are no effective supply constraints in the system. (See Thirlwall 1979 for a typical example of this view.)

Export-led growth means exporting more without importing more. That increases demand, which therefore increases growth. The analysis has no supply constraints.

The third major exponent of the view that the exchange rate is important in determining growth was an altogether more subtle thinker, Bela Balassa (e.g., Balassa 1982, chapter 4). Balassa believed that exchange rate policy was one of the keys for a country's development because, if it had an exchange rate sufficiently competitive to motivate its entrepreneurs to go and sell things other than traditional export commodities on the world market (what he described as a "realistic" exchange rate), they would also want to invest and expand employment and the economy would grow. At the other extreme, if the country got too much easy money from oil exports, or aid, or capital inflows, then its exchange rate would be driven to a point where there is no money to be made from non-traditional exports. It will be more profitable to squabble about getting a share of the rents than to invest, produce, and contribute to the economy's growth. The country will suffer from Dutch disease. Since Balassa's day empirical evidence has been presented which suggests that growth, and therefore the standard of living if one takes a sufficiently long-run perspective, is inversely correlated with resource endowments (Sachs and Warner 1995). This result appears highly counter-intuitive from the standpoint of traditional theory, but it provides striking evidence that Balassa was right and that Dutch disease is dangerous.

Balassa's conviction was based on his observation of the success of the East Asian economies—initially Hong Kong, Korea, Singapore, and Taiwan, and then the countries of Southeast Asia—in launching rapid and sustained development. Most of these economies went through an early phase of import-substituting industrialization, but instead of maintaining this strategy to the point where it obligated them to try and build sophisticated industries for which their factor endowment was not (then) suited, they relieved their foreign exchange shortage by starting to export simple manufactures. Over time their manufacturing base expanded and they came to produce and sell in the domestic market, and subsequently export, a wider range of manufactured goods. Before the East Asian crisis several of these countries had used their rapid export growth to convince the markets that they were a good destination for capital, and they were using the resulting capital inflows to finance large current account deficits.<sup>1</sup>

China is a more complex case, since its early reforms expanded supply primarily in the agricultural sector, and it was this sector that provided the boost to demand that initially drove growth. Only later in the 1980s, and into the 1990s, did the relaxation of planning and import controls allow market incentives to become important. A cumulative real devaluation of the renminbi of some 70 percent between 1980 and 1995 gave a crucial boost to the profitability of exporting, so that Chinese growth became dependent on export sales as in other East Asian countries.

So this is my second major conclusion from the historical experience of the last half-century: *In order to have a chance at developing, a country needs to maintain a competitive exchange rate.* (I define a competitive rate as one that is not overvalued, *not* as one that is undervalued.)

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<sup>1</sup> The current account deficit averaged 2.3 percent of GDP in Indonesia, 5.7 percent of GDP in Malaysia, and 6.5 percent of GDP in Thailand during the five years 1992-96.

I have endeavored to embody Balassa's insights into a formal model of what I call the "Development Strategy Approach" to the choice of exchange rate regime (Williamson 2003). This recognizes, along with Balassa, the Deutsche Bank economists, and the Cambridge Keynesians, that a competitive exchange rate is important in creating an incentive to export and, because exports require investment, an incentive to invest. But it also recognizes, unlike the Deutsche Bank economists and the Keynesians, that investment can be constrained from the supply side as well as from the demand side. A hyper-competitive exchange rate will tend to generate a current account surplus, which will preempt real savings that could instead have been used to increase real investment, and so the lower investment will constrain the rate of growth. The growth-maximizing exchange rate is that at which these two effects balance at the margin.

### **The Conditions for a Fixed Exchange Rate**

The combination of events and analysis have also created a good understanding of the conditions that need to be satisfied in order for a fixed exchange rate to make sense. Some years ago I in fact laid out what I saw as the essential conditions for it to be sensible to fix the exchange rate—firmly fixing it for "ever", not temporarily fixing it until some shock makes the politicians decide that it would be advantageous to change (Williamson 1991). I quote what I then wrote:

1. The economy is small and open, so that it satisfies the conditions for being absorbed in a larger currency area according to the traditional literature on optimum currency areas.
2. The bulk of its trade is undertaken with the trading partner(s) to whose currency (or whose mutually-pegged currencies) it plans to peg. This is necessary if stability of the bilateral exchange rate is to secure a reasonable measure of stability of the effective exchange rate that is essential for macroeconomic stability. What is meant by "the bulk of its trade"? I would settle for a 50 percent threshold as a working figure, because 60 percent seems more than enough and 40 percent seems too little.
3. The country wishes to pursue a macroeconomic policy that will result in an inflation rate consistent with that in the country (or countries) to whose currency (or currencies) it plans to peg. This policy will be sensible if the center currency provides a stable anchor and the domestic economy is capable of living comfortably with price stability. Conversely, it will be foolish if the center country suffers rapid inflation or the domestic price level has a life of its own, either because fiscal indiscipline entails reliance on the inflation tax<sup>2</sup> or because cost-inflationary pressures are entrenched.
4. The country is prepared to adopt institutional arrangements that will assure continued credibility of the fixed rate commitment. This may best be established

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<sup>2</sup> The "inflation tax" is the loss in real income that is suffered by those holding money balances (which typically pay zero interest) in the presence of inflation. The idea is that a government that generates an inflation balances its books by issuing more currency, which the public has to acquire in order to hold the real value of its money holdings at an adequate level when the real value of existing holdings is being eroded by inflation.

by replacement of a central bank, having the ability to finance fiscal deficits, with a currency board. Alternatively, an independent central bank committed to the fixed rate (for example, that of Austria<sup>3</sup>), or participation in an international agreement that has established credibility such as the European Monetary System, may suffice... A common currency, of course, will guarantee total credibility.

The two conditions that are clearly not satisfied by China are the first and second. China is not by any stretch of the imagination a small economy (though it is a remarkably open economy for one that is so large). And it does not trade predominantly with the United States. Even on the export side, it sends only some 21 percent of its goods directly to the US market, while only some 8 percent of its imports come from the United States (on Chinese figures, from the Ministry of Commerce). Including re-exports from Hong Kong to the USA would boost the export figure to 30-35 percent, still only about a third. The figures would be 4 or 5 percent higher if one counted the whole of the Western Hemisphere as in a dollar area. Only if one were to include all Asian countries other than Japan (as some economists, like Ron McKinnon, would regard as appropriate) would trade with the dollar bloc dominate China's trade: that would make 58 percent of exports going to, and 56 percent of imports coming from, the dollar bloc. However, what these figures suggest is not the rationality of pegging to the dollar, but the importance of adopting an exchange rate policy that will avoid arbitrary changes in exchange rates against China's Asian neighbors. There are other ways of achieving that than by pegging to the dollar.

There seems no compelling reason to regard the third condition as precluding a fixed exchange rate with the dollar. The recent acceleration of inflation in China is a direct and predictable result of the decision to try and hold a fixed nominal dollar exchange rate despite the evidence that the rate was undervalued, and should not therefore be interpreted as implying that China would have difficulty in living with the US inflation rate.

The fourth condition is essentially a question of political will. A Chinese audience may question my credentials to pronounce on this issue, but I confess that I would be surprised if China were prepared to accept the renunciation of sovereignty it would imply.

I conclude that China is not a natural candidate for a fixed exchange rate against the dollar. It is not small, it does not trade predominantly with the United States, and it is not clear that it is prepared for the renunciation of sovereignty that a truly fixed rate implies. (But it does have an important national interest in avoiding sharp and arbitrary variations in its currency vis-à-vis those of its neighbors.)

### **Intermediate Regimes**

While there is still a tendency to assume that dismissal of a fixed rate implies adoption of a freely floating exchange rate, there is a range of other options, consisting of the various intermediate regimes. One can in fact argue that China already employs one of these, namely the adjustable peg—a system under which the exchange rate is fixed in the short run, but the government retains the right to alter it if it thinks the circumstances point to a

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<sup>3</sup> Remember that this was published in 1991, long before the euro was introduced.

change being needed. However, what I intend to explain are the less-familiar regimes of “target zones” and “monitoring zones”.

A *target zone* system consists of a parity, a rule for changing the parity, and a band around the parity within which the rate floats. The first issue is to decide in terms of what the parity—or central value of the currency—will be expressed. This is most commonly a single other currency, such as the US dollar or the euro (for the potential new members of EMU in East and Central Europe) or the South African rand or whatever. It is also possible to use a composite currency unit like the SDR, or a basket of currencies with defined weights (which is how the SDR itself is valued).

The second issue is to decide the actual value of the parity. This means in practice to decide how the value of the parity will be changed over time. One question is whether changes in the parity should be small and frequent or delayed as long as possible in the hope that they will in the end prove unnecessary. Experience—such as the relative lack of speculative crises during the years when the EMS was accepting frequent small parity changes as a regular part of the system—suggests that it is much better to have small, frequent changes than large, occasional ones. In fact, it has been shown that the parity change ought always to be less than the width of the band. This means that market operators cannot be sure that after the parity change the market rate will be such as to give them a profit from speculating on the change, *even if they are sure that a change in that direction is about to occur*. Small frequent changes of this type are usually referred to as a *crawl* of the exchange rate.

There is also a question as to who decides on a change in the parity (“the crawl”), the government or “the market”. Most usually governments have made this decision, after looking at forecasts of the economy. If they see a danger of the economy becoming uncompetitive because inflation is running faster than in the other countries with which they trade, they devalue. Or if they foresee a current account deficit that they would have difficulty in financing, then they aim to trim the deficit by devaluing. Conversely, an economy with unusually low inflation (and which wishes to maintain its low inflation) or in a particularly strong payments position will see its interest in revaluing its currency. The alternative approach is to adopt a formula that changes the parity automatically in response to some rule. For example, before the Asian crisis Korea had a policy of changing the parity each day by a fraction of the deviation of the previous day’s rate from the parity, so that persistent market pressure would lead to a gradual appreciation or depreciation.

The third issue is to decide the width of the band within which the exchange rate will be allowed to fluctuate in response to market forces. I have argued that there are four important advantages in choosing a wide band, of as much as  $\pm 10$  percent or even  $\pm 15$  percent (Williamson 2000, p.7). One purpose is to make sure that the authorities do not get into the no-win situation of defying the first lesson above and trying to defend a disequilibrium exchange rate. Since no one imagines that it is possible to estimate equilibrium at all precisely, this demands a wide band. A second purpose is to permit the parity to be adjusted to keep it in line with the fundamentals without provoking expectations of discrete changes in the exchange rate that might destabilize the market (as described above). A third reason is to give some scope for an independent monetary policy to be used for anti-cyclical purposes when a country finds its business cycle out of sync with the world norm. Finally, the wide band should give a country some help in

coping with strong but temporary capital inflows; to the extent that market operators find the band credible, they will allow for a rebound of the rate toward parity when they calculate the yield that is attracting (or repelling) them. And to the extent that investors in the tradable goods industries find the band credible, they will look to the parity rather than the market rate in deciding whether to go ahead with potential investment projects, implying that a given deviation from equilibrium will have less effect in distorting investment decisions.

Rudi Dornbusch once referred to these rules for exchange rate management—a basket parity, a wide band, and a crawl of the exchange rate—as the “BBC Rules”. This is the intermediate regime that I favored prior to the Asian crisis.

However, one of the things that happened during the Asian crisis is that a country using essentially these policies for managing its exchange rate (I refer to Indonesia) got hit by contagion. After a while it decided to let its exchange rate float, after which all hell broke loose as all those companies that had borrowed dollars ran to buy dollars to cover their exposure before the rupiah collapsed. Of course, this precipitated the very collapse that had driven the stampede to buy dollars in the first place. And the collapse of the currency led to an implosion of the whole economy.

One conclusion that I drew from this is that a country needs to be able to let its currency depreciate during a crisis, so as to persuade foreign holders to terminate their selling, and also to have a mechanism to secure a relatively rapid improvement in the current account balance. Another conclusion is that too much predictability of the exchange rate encourages domestic residents to take loans denominated in foreign currency, which can then produce debt distress when the foreign currency appreciates in terms of the domestic currency.

The first of those conclusions suggested a need to re-think the exchange rate system that I have favored. I had always argued that a country with a BBC system would be able to avoid a crisis: the basket would prevent its currency becoming overvalued because of shifts among the exchange rates of the major currencies; the band would give scope for some immediate adjustment of the rate and would provide plenty of scope to adjust the parity; and the crawl would prevent the parity being out-dated by differential inflation. What this did not allow for was a currency being clobbered by contagion as happened in Indonesia. Is it possible to conceive of a system that would be invulnerable to this risk?

The answer seems to me to be to weaken the band into a *monitoring band*. This was an idea launched in the Tarapore report (1997), the report of a committee set up by the Indian government in order to lay out an approach to establishing capital account convertibility in India. Although the main recommendations of the committee were made irrelevant by the East Asian crisis, this particular idea is worth preserving. The idea of the committee was to surround the parity by a band (they suggested +/- 5 percent) within which the authorities would be *prohibited* from intervening (or taking other actions designed to influence the exchange rate). If the rate went outside that band, they would be allowed to intervene to push it toward the parity, but they would not be compelled to intervene. So the market would still get guidance from the authorities as to what exchange rate they believed to be consistent with their other macroeconomic policies; the authorities would still have the right to try and keep the market rate reasonably close to that ideal rate; but they would not be compelled to keep it close, so that in a crisis they

could let it go further from parity without the confidence-destroying effects of abandoning an exchange rate commitment. (And companies would have a greater incentive to cover their foreign-currency borrowing, because they would know that the authorities had no obligation to keep the rate close to the monitoring zone.)

Critics ask why such a loose commitment should be expected to have any impact on market exchange rates. It is quite reasonable for those who are convinced that intervention in the foreign exchange market is ineffective to pose that question. But I submit that one cannot believe both that intervention can influence a floating exchange rate via what is termed the “information channel” *and* that a monitoring band can have no effect, for it too provides the market with essentially the same information, and in a more direct way. Whether such an information channel exists, and how powerful it is, remain disputed topics among economists.

### **Implications for China**

I have already indicated the reasons I think a (truly) fixed rate is inappropriate for China. To judge by their declarations that they plan eventually to move to a floating exchange rate, the Chinese leadership does not dissent from this judgment. Those declarations also suggest that they plan to move all the way to largely unmanaged floating as currently practiced by most of the industrial countries, rather than to something like the monitoring band that I sketch above. This I regard as a mistake, because the unmanaged float has proved itself a midwife for misalignments, repeated crises, and massive current account imbalances reflecting perverse capital flows. I do not understand why China should want to expose itself to those shocks.

Nevertheless, it is still interesting to ask what is going to happen between now and the long run when China gets a floating exchange rate. One possibility is to try and muddle through with the present policy of pegging to the US dollar. This I think would be a mistake, for several reasons:

- The renminbi is badly undervalued at the moment, as demonstrated by the fact that China still has surpluses on both current and long-term capital accounts, despite the fact that the economy is overheating (as reflected in an acceleration of inflation of about 5 percent over the past year). The result is that China has to make substantial investments in US Treasury bills, despite these having a much lower yield than the benefits that China could expect to get from using those resources to increase its consumption.
- The only hope of adjusting the Chinese current account with the present dollar exchange rate would be a substantial inflation in China (my guess would be of the order of 20 to 30 percent). If such an inflation got under way it might acquire inertia that would make it difficult to stop at just the point that would leave the economy internationally competitive but without an undervaluation.
- If the attempt to cool the economy through administrative measures succeeds, then the currency will still be undervalued. Overheating will return (though perhaps only after a time of slowdown), and there will again be a need to cool the economy in which market measures (currency appreciation and a higher interest rate) will still remain out of bounds.

- Undervaluation is attracting a continuing speculative capital inflow that makes it difficult to avoid excessive lending, with its high likelihood of a new crop of bad loans.
- Other Asian countries are very reluctant to contemplate substantial appreciation with the renminbi at its present value for fear of losing out (in terms of both trade and investment) to China. This makes it very difficult to complete the adjustment in the value of the dollar, which is necessary even to prevent the US current account deficit increasing and its debt exploding. With the US current account deficit at its present level the US debt increases continually relative to GDP, which means that the likelihood of a major international crisis is growing ever larger.

The most promising alternative strategy seems to be something along the lines of the “two-part reform program” outlined by my colleagues Morris Goldstein and Nicholas Lardy (2003). Their first stage of reform would involve a one-shot revaluation of 15 to 25 percent followed by re-pegging the renminbi but to a basket (of dollar, yen, and euro) and with wide (+/- 10 percent) bands. As emphasized above, a large one-shot revaluation has the disadvantage of paying a substantial reward to those who speculated on the revaluation, and this may make it more difficult to build confidence that such moves will not be repeated in the future. However, while it makes sense to try and avoid the emergence of large disequilibria by making small and timely moves instead of leaving them until large disequilibria have emerged, it is now too late for that. At this stage there seems no reasonable way of avoiding a substantial one-shot move, which is certainly what one would have to expect as the first move of a floating rate.

China may reasonably ask whether there is not a danger of such a move overshooting and leaving an overvalued currency in its wake. This would of course contravene the two principal lessons for exchange rate policy that I suggested above. This is a danger that cannot be totally avoided unless one accepts the risk of ending up with a rate that is still distinctly undervalued, which would be likely to aggravate rather than end the speculative capital inflow whose elimination would be one of the purposes of the exercise. Nevertheless, there are three ways of minimizing this risk.

- Negotiate with other Asian countries to make sure that they participate in a general currency realignment at the same time as China moves, so that China does not suffer an excessive loss of competitiveness vis-à-vis its neighbors.
- Allow a wide band around the new peg as suggested above, so that there is scope to move a bit further if the move turns out to be too small and to backtrack a bit if the move turns out to be too large.
- Lastly, and obviously, do the sums to decide how big a move to make carefully.

Goldstein and Lardy’s “second step” is in fact a series of steps, the aim of which is to end up with a floating, convertible currency much like any other major country. This series of reforms should start off with measures to make sure the banking system is well-capitalized and sound. Only after this is it safe to liberalize the domestic banking system, which should in turn be done before full liberalization of capital flows. And only after some liberalization of capital flows does it make sense to float the currency, because a

floating currency needs the banks to be able to adjust their foreign holdings of currency in order to stabilize the foreign exchange market. (A float can in name be implemented sooner, but if the government still has to intervene to stabilize the market then it is really the government rather than the market that determines the exchange rate.)

As stated above, I personally would not wish to see the final end-point being a system of unmanaged floating similar to that practiced today by the G-7 currencies: I would prefer that China aim for a system of monitoring zones. But that is irrelevant to the sequence of moves laid out above, the essential points of which are:

- start by a substantial one-shot revaluation;
- move to a system with limited flexibility around a basket parity, and limited freedom for banks to change their foreign positions so as to learn how to operate a foreign exchange market;
- keep the parity up to date by periodic small changes as needed;
- move carefully to a liberalized financial system, starting with measures to make sure the banks are and remain solvent and well-capitalized and only in the final stage (possibly many years ahead) moving to full capital account convertibility.

### **Concluding Remarks**

China, like many of the East Asian countries when they got growth going, has for some years benefited from a highly competitive exchange rate. It needs to be sure that this advantage is not lost as it adjusts its exchange arrangements: the very worst thing that could happen would be to get into a position of trying to defend an overvalued exchange rate. But this imperative is not best advanced by the present policy of maintaining a fixed nominal bilateral exchange rate against the US dollar. This policy has led to a depreciation of what really matters from the standpoint of macroeconomic policy, the real effective exchange rate. It poses the danger of igniting domestic inflation in China; while such inflation would at best lead to adjustment that would substitute for an exchange rate appreciation, it does so by sacrificing domestic macroeconomic stability. Moreover, it carries a risk that the inflation will be difficult to bring back under control when international adjustment is complete and will thus lead the country into a period of the very worst situation, overvaluation. It results in wasting resources by stockpiling low-yielding US Treasury bills, when China has far better uses for those resources by adding more rapidly to its people's consumption. Quite apart from the impact on the rest of the world and the danger that China will suffer from the reactions that its policies will provoke, China has a strong national interest in adjusting its policies by a one-shot revaluation followed by a careful process of liberalization.

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