

Prospects for A New World Monetary System and Implications for Korea

John Williamson

Present international monetary arrangements suffer from two principal problems. The first is that floating exchange rates did not live up to the promises that had been made by the literature of the 1960s, which seemed to promise that they would provide a painless mechanism for resolving balance of payments problems and ridding the world of international monetary crises. When put in practice in the 1970s, however, the system of flexible exchange rates did not work out like that at all. We saw instead very violent movements in exchange rates that at times led to severe misalignments—that is, exchange rates that were not consistent with the fundamentals, and in particular that were not consistent with external balance (meaning balance of payments positions free of unsustainable deficits or surpluses). At times these misalignments were so large as to threaten crises as severe, though of a different form, as those that had occurred under the previous regime of fixed but adjustable exchange rates.

Fixed exchange rates had also generated exchange rate misalignments. This often happened through an inflation rate in one country being higher than in its trading partners. Speculative crises occurred when the market sensed that an exchange rate adjustment was inevitable. Advocates of floating rates had argued that similar things would not happen when exchange rates were free to adapt in response to market forces. In fact, however, exchange rates often got carried away by speculative bubbles. Recall the

dollar in the mid-1980s, when it became way out of touch with the fundamentals. One can argue that the initial rise in the dollar, over a two- or three-year period, might have been caused by the rather peculiar policy mix the first Reagan administration adopted—an enormously expansionary fiscal policy and a very tight monetary policy, which propelled the dollar to a much higher level. But there is no rational explanation for that final surge during the last 8 months (at least) of the dollar's rise, when it rose another 20% or more. The dollar lost touch with reality.

This simply had to lead to some sort of crisis. The form the crisis took was a torrent of protectionist legislation in the U.S. Congress. Even though the US Treasury at the time did not worry about the dollar being overvalued, US congressmen, who had to answer to constituents who were losing jobs because they could not compete in the international marketplace, most certainly did. Since the Plaza Agreement, the Group of Seven has been operating an informal target zone system, at least as regards the dollar. Exchange rates have been managed either through intervention in the exchange market or through such incidents as the recent jawboning intended to prevent the dollar from staying so weak. Unfortunately policy did not focus similarly on preventing other major currencies from developing misalignments. In particular, it didn't prevent the yen from getting too weak again in 1989 and 1990, a development that reversed the progress initially made in reducing the Japanese balance of payments surplus. The recent recession in Japan, coupled with recovery in the United States, once again led to an uncomfortably large Japanese balance of payments surplus, which has created political pressure in Washington to take action against Japan. The Clinton administration now seems to be committed to a policy of wringing trade conces-

sions from Japan, even though the concessions may be so modest they are not worth the trouble in terms of the loss of confidence the dollar. So, I would maintain that, even since the Plaza, misalignments in the exchange markets remain an important problem.

The second major weakness of the international monetary system—or non-system as some of us would call it—since the breakdown of the Bretton Woods monetary system in 1971 is that it does not put enough pressure on the major countries to discipline and coordinate their macroeconomic policies. They are given too much of a free hand, which is manifested in two ways. First, governments are free to adopt short-sighted policies. Here again, the first Reagan administration is the prime case in point. Allowing a big budget deficit to emerge while squeezing out inflation through monetary policy was a very dangerous policy combination that, as predicted, created a whole series of problems, of which overvaluation of the dollar was only one. There were also large balance of payments imbalances among the major industrial nations, growing levels of indebtedness that generated increasing burdens of interest payments, and so on.

Second, fiscal policies are in general far too loose. This is the case virtually throughout the world, with the exceptions of Japan and a few of the smaller countries, like Mexico and Singapore. It would be helpful to shift the mix of fiscal and monetary policies towards tighter fiscal policies compensated by lower interest rates.

One can argue that the Bretton Woods system as it was designed at the Bretton Woods Conference in 1944 was the most successful monetary system the world has ever known. Each country had an obligation to keep its exchange rate constant at a level that avoided misalignments, and it also had an obligation to keep employ-

ment fairly full. This meant that when one country developed a balance of payments deficit and had to restrict its demand, some other country in the system had a surplus and was induced to relax its policy, thus desynchronizing the world business cycle. During the 1960s, there was no *world* business cycle. Of course, there were still a series of *national* business cycles: there were recessions in 1960 in America and in 1966 in Germany and Japan had to tighten up periodically, but the rest of the world went bustling on. Only after the breakdown of the Bretton Woods system in 1971 did a global business cycle return.

Unfortunately, although Bretton Woods was a very good system in terms of managing the world economy, it was not a robust system. Robert Triffin began to worry about its fragility already in 1959. His argument was that the system relied on the U. S. balance of payments deficit to furnish the increasing supply of reserves that a growing world economy needed, and yet the United States ability to honor its commitment to defend the convertibility of the dollar into gold would be increasingly called into question as its liabilities were increased by the payments deficits that fed the increase in reserves. Hence the world faced a choice between the strangulation of growth by an increasing reserve shortage and a confidence crisis that would force the U.S. to abandon its obligation to defend its currency in gold. This was the first respect in which the system was inherently crisis prone.

It was crisis prone in another respect as well, with regard to the exchange rate system. When a country had a fundamental disequilibrium—that is, it could not hope to defend its existing exchange rate on the basis of demand management without running into either a serious slump or serious inflation—it was supposed to change its exchange rate. But because countries were supposed to

treat exchange rate changes as a last resort, they typically changed rates by as much as 10, 15, or 20% when the need for a change was finally recognized. Traders on the foreign exchange market could see that a devaluation might happen, in which case they would gain by speculating against a currency, while there was no danger of the currency appreciating, so that they stood to lose nothing if devaluation did not occur. Given such a one-way option, it was smart to move money out of a threatened currency quickly. As international capital mobility increased, it became less and less possible to manage this exchange rate system as originally envisaged; that is, with a substantial measure of exchange rate flexibility.

These matters were discussed during the meetings of the Committee of Twenty that was supposed to reform the international monetary system during the years 1972 to 1974, but the proposed designs for a new system were inadequate, and no agreement was ever reached. The world therefore decided to try to live with the present “non-system” based on floating exchange rates. But, as I already indicated, problems of volatility and especially repeated misalignments of exchange rates emerged, and some economists began to propose designing an intermediate regime that would regain some of the benefits of the Bretton Woods system, notably by limiting currency misalignments. The minimal change that is needed is a target zone system for exchange rates among the major countries, at least the Big Three (the United States, Germany and Japan). Ideally, it should be the G-7—i.e., adding France, Britain, Italy and Canada.

Let me describe how we conceive that these target zones would work. First, one would center the target zones on best estimates of what I call “fundamental equilibrium exchange rates”. “Funda-

mental equilibrium” is conceived as the opposite of fundamental disequilibrium in the old Bretton Woods sense. In a fundamental disequilibrium, a country cannot maintain the existing exchange rate without running into serious problems with its internal balance. Fundamental equilibrium is the opposite: the exchange rate that *is* consistent with the simultaneous achievement of internal and external balance.

Of course, this definition raises the problems of defining internal and external balance. The definition of internal balance is not too hard: noninflationary full employment is the traditional formulation. A more precise definition might be “the maximum level of employment consistent with the continued control of inflation.”

External balance is much more tricky. It would make no sense to prevent current account imbalances, for capital flows perform real functions in the world economy. Korea could not have developed as fast as it did had it not imported capital over a long span of years, and many other countries now need to import capital on a significant scale to accelerate their development. But remember that Latin America lost a decade’s development during the 1980s because they had imported capital on too large a scale without building up assets that would have enabled them to service their debts during the 1970s. It is possible for a fast-growing country to import 4% or conceivably even 5% of its GNP on a sustained level; but, beyond that, it is asking for trouble. If deficit countries are going to limit their deficits, the laws of arithmetic imply that surplus countries will have to limit their surpluses. The calculations I have done suggest that a fair sharing of the available surpluses might allow Japan to run a surplus of up to 2% of its GNP without creating a problem for the rest of the world. That is the nature of the debate that would arise in setting explicit

guidelines for current account targets, and doubtless it would involve much international bickering. But if that enabled the world to avoid the sort of unpleasant, counterproductive, bilateral arguments over trade that have arisen recently between the U.S. and Japan, it would be well worthwhile.

The second feature of the target zone system is that the center of the target zone should be surrounded by wide margins. At Bretton Woods, currencies were only allowed to fluctuate by plus or minus 1%. The Exchange Rate Mechanism of the European Monetary System originally set margins of plus or minus 2.25%. Those margins have not proved wide enough to accommodate today's capital mobility. In order to make the target system work, it is probably not necessary to have a band as wide as the present ERM, +/- 15%.

An important way in which our proposals differ from the practice of the ERM is in including small, regular revisions in the bands. Periodically, perhaps monthly, quarterly, or annually, when inflation figures come in, a country would change the central rate and hence the zone by 0.4%, or whatever is needed to offset differential inflation and leave the real rate unchanged. With a zone 20% wide, the market would be unlikely to get excited about a prospective need to adjust the central rate by 1% or less.

It would also be necessary to adjust the zones in order to keep them up to date by allowing for real shocks. The classic example of a real shock is what happened in Europe in 1990: German reunification, involving West Germany's taking on the responsibility of reconstructing East Germany. What had been a high-saving, budget-surplus country with a balance of payments surplus suddenly became a country a big budget deficit, due to spending so

much on reconstruction. Germany tried to make that change without appreciating the deutschemark within the Exchange Rate Mechanism of the European Monetary System; they failed, which is not too surprising. One way to accommodate the real shock would have been for Germany to allow 10-20% inflation in order to adjust its balance of payments to get an import surplus. But, since the Bundesbank does not like 10-20% inflation, that solution was ruled out. Germany therefore needed a nominal exchange rate change. By trying to do without, Europe blew up the old ERM.

The system we are proposing would explicitly allow such changes in the real exchange rate when needed to accommodate a real shock. Let us hope that if one day Korea faces the German problem, and has to take on the responsibility of reconstructing the North, that it will learn from what Germany has done. Korea can do better than Germany if it has a target zone and is prepared to modify it appropriately.

How is a target zone to be defended? The first line of defense is sterilized intervention, meaning that the central bank doesn't allow intervention to change the domestic monetary base. For a long time, there was a great deal of skepticism as to whether sterilized intervention accomplished much. But new studies by Jeffrey Frankel and Kathryn Dominguez (published by the Institute for International Economics, 1993) and by a team of economists at the Banca d'Italia (Catte, Galli and Rebecchine, 1992), both of which had access to daily data on exchange interventions, reached a very different conclusion as to the effectiveness of sterilized intervention. They show that such intervention has often worked in the G-7 context, but argue that this requires certain conditions to be satisfied. First, it has to be concerted intervention. Any suggestion to the market that Germany and the U.S. don't

agree about where the exchange rate ought to be going is likely to make intervention ineffective, no matter how much money is committed. The intervention also has to be public, and preferably it has to have an element of surprise. And, needless to say, the intervention has to be in defense of a realistic exchange rate. Under these conditions, intervention can be much more effective than has often been believed. On the other hand, one would have to be a great optimist to conclude from this evidence that sterilized intervention is an absolutely dependable policy. There will still be circumstances under which it will be necessary to back up intervention with changes in monetary policy.

A target zone system along the lines that I have described would require management by a small group of countries in order to coordinate the setting and implementation of policy. It is unrealistic to expect that the G-7 might agree to take orders to change their exchange rate policy from the IMF Executive Board. The problem is that allowing a small group like the G-7 to manage the system raises the issue of legitimacy. The rest of the world may question the fairness of having the G-7, which represents some 45% of IMF quotas, 50% of gross world product, and not much over 10% of world population, taking this power upon themselves. Hence the question arises of how these two criteria of legitimacy and efficiency could be reconciled?

What we suggest is to leave management in the hands of the G-7 but to make it subject to surveillance by the IMF. This could not be done by the IMF Executive Board in its present form, because that is composed of officials far junior to the Ministers who meet in the G-7, but it could be done by the ministerial-level IMF Council that was provided for in 1978, when the IMF Articles of Agreement were amended. This provision was never put

into effect, and as a result there is to this day an Interim Committee, which meets twice a year, but which originally was supposed to function merely as a stopgap until the council was created. Twenty years later we think it is high time to create the council as a ministerial-level body so as to exert meaningful surveillance over the G-7.

It would also be possible to embody this idea of target zones for exchange rates within a more comprehensive system of policy coordination. Marcus Miller and I made proposals as to how that could be done in 1987. We created what we called a “blueprint for policy coordination” in which we suggested that it was desirable to coordinate not just exchange rates, but also fiscal policy and the general level of world interest rates.

Without going into details, let me sketch out some simple reasons as to why this could be important. Suppose this system had been in operation in the early 1980s, when the Reagan budget deficit emerged and the dollar was going through the ceiling in consequence. Suppose one then intervened to dampen the rise of the dollar, but that this had not stopped the dollar’s rise. The next policy action would have been for the United States to cut interest rates so as to stop the dollar’s appreciation. But high interest rates were at that time just succeeding in curbing inflation, and cutting them would have risked undoing all the sacrifices made in getting inflation down. In that situation, what was needed was not just a cut in interest rates, but a cut in interest rates combined with a tightening of fiscal policy so as to avoid an acceleration in U.S. inflation. That illustrates why fiscal policy should be part of systematic policy coordination.

What chance is there of any such changes being made? The last major international monetary initiative was the creation of the

European Monetary System in 1979, which was a response to the perception of a crisis caused by the weakness of the dollar and the desire to insulate Europe from that weakness. The ERM's abandonment of narrow margins in August of last year was a response to a speculative crisis. Most regime changes have historically been made in response to crises, and since one of the few virtues of present monetary arrangements is that they do not appear very vulnerable to major crises, one might conclude that the prospects for reform are not high. However, since the nature of such crises is that they are not foreseeable, one should not dismiss this possibility completely.

Furthermore, sometimes far-seeing statesmen come to power with a conviction that reform of the system is important. Think once again of the formation of the European Monetary System. The fact that the crisis elicited a constructive response was due to the simultaneous presence in office of two powerful politicians in the two most powerful nations in Europe, two statesmen who had previously been finance ministers and therefore understood economics and could agree on a solution: Giscard d'Estaing in France and Helmut Schmidt in Germany. They were not afraid of losing freedom of national action. On the contrary, they thought it was a good idea to limit freedom of action, even for their own countries, because they wanted to prevent their successors from acting irresponsibly. Indeed, it was this solution that prevented the Mitterrand government from going protectionist just four years later, in 1982; accounts indicate that it was decisive that France was part of the European Monetary System, abandonment of which would have set off all sorts of alarm signals around the world. So one should not exclude the possibility that reform might one day come through a deliberate political decision.

Finally, let me discuss the implications of a target zone system for a nation such as Korea. Let me start off on the assumption, which is certainly valid as of now, that Korea would not be one of the nations whose exchange rate would be included in the set of internationally agreed target zones. I think there are three ways in which such a system would affect Korea.

First, the benefits of such a system would be world-wide. When Jeffrey Sachs and Warwick McKibbin tried running simulations in the 1980s to assess the implications of better policy coordination, they concluded that non-member countries, particularly the heavily indebted countries, would have benefited most, because better coordination would have meant lower interest rates and therefore lower burdens for debtor countries. Another way in which non-members of the G-7 could expect to benefit from a system of target zones among the G-7 is by the reduction in intra-G7 exchange rate variability. Variability in the exchange rates among the main currencies imposes costs on third countries, since the movements are totally capricious from their point of view. Sometimes they may happen to be beneficial, as the dollar's recent depreciation in relation to the yen may have been for Korea. Yet it is equally likely that next year the dollar will rise against the yen, with resultant problems for Korea. Reducing this capricious variability would be helpful, e.g. in avoiding the danger that Korea might gain or lose competitiveness against East Asian competitor countries as a by-product of a move of the dollar against the yen.

One other benefit of target zones for small nations is the reduced danger of confronting protectionist pressures. The overvaluation of the dollar led to protectionist pressures in the United States. Under a system of target zones, the United States would

avoid misalignments and thus should face reduced protectionist pressures.

The second effect of target zones on nations such as Korea is that the IMF would expect all its member countries to engage in the exercise of agreeing targets for the current account of the balance of payments. I discussed earlier the need to define external balance, i.e. balance of payments targets, in order to calculate fundamental equilibrium exchange rates. But it does not make sense to do such an exercise simply for the G-7 without looking at the rest of the world, since global consistency of the targets is the essence of the exercise. Other major players in the world economy, such as Korea, would therefore have to be involved. I hope that this prospect will not be regarded as a disadvantage; I see no reason why it need be a burden.

The third effect is that Korea, like other countries of the IMF, would gain an input that it lacks at the moment into G-7 deliberations. By virtue of the fact that the G-7 would have to report to the IMF Council and the IMF Council would represent all members of the Fund, those other members—Korea included—would have the opportunity to question G-7 decisions and implementation.

Let me finally mention the possibility that although Korea is not today a candidate for membership of the G-7, that might one day change. If and when Korea is reunified, it will have a population of more than 60 million. Three of the members of the G-7 have populations in exactly that range, while Canada has a substantially smaller population. Korea at the moment has a much lower per capita income, but you are rapidly catching up. With continued progress, a unified Korea would before long have a GDP comparable to that of some existing members of the G-7. Under those circumstances it would be difficult to keep the G-7 as it is today

and exclude Korea, giving you both the responsibilities and the advantages of full membership.

Discussions

Q Dr. Kihwan Kim (Chairman, KOPEC)

I would basically like to raise two types of questions. The first one concerns preparing the economy for your proposal. You talked a lot about the benefits. It all depends on how well the system would work and the cooperation among the G-7. One reason in my view why the flexible exchange rate did not work has more to do with the lack of cooperation than the poor system itself. For this reason, I would like to have your view on the kind of cooperation we could expect in the event your system is adopted. The second set of question is more technical. You talked about a plus or minus 10% target zone. I am wondering whether this band is soft or really hard. In other words, are you willing to allow the exchange rate to overshoot the zone now and then or just keep within the 20 percent range? The second part of the question has to do with the timing of the revisions. You said that there should be regular revision of the central rate, and you talked about monthly and yearly revisions. Is that really practical? Can you do it every month or every year? The third part of my technical question relates to the real shocks - that the system should allow adjustments to real shocks. What real shocks do you have in mind besides unification?

A Dr. Williamson

On the first question, I agree that the system depends on cooperation. However, I believe that the amount of cooperation that

is achieved depends on the rules built into the system—in particular, on whether the cooperation being sought is reasonable. If you ask countries to sacrifice their national interest without gaining some quid pro quo, they won't do it. You have to design a system in which there are the prospects of benefits that are worth some sacrifices. The benefits may be inter-temporal: i.e. a country may agree to shape its policies today in a way that is consistent with some rules that are generally accepted as fair, in the expectation of gaining greater benefits in the longer term. A system that creates such expectations has a much greater chance of inducing cooperation than the sort of *ad hoc* system under which the world has been operating since the breakdown of the Bretton Woods regime.

Your second question was whether the band should be hard or soft. That is an issue on which we have not reached a unanimous answer at our Institute, which is perhaps why I have not been explicit on it in recent years. As I originally conceived target zones, they would have been soft, so that in extreme situations the rate could go outside the band. In effect, the authorities would say: "We think this is a misalignment, and we shall try and persuade the rate to come back to the band through various policy actions, but we are not prepared to intervene to an unlimited extent to prevent the rate moving outside the band." If the market decided to take the rate outside the band, a country need not distort its monetary policy to a dangerous extent in order to keep it within the band. On the other hand, the Director of our Institute, Fred Bergsten, has taken the view that sloppiness in defending the band would threaten its credibility.

Regarding the third question, on the regular revision of central rates, I envisage monthly changes being made only to offset infla-

tion differentials. The additional revisions necessary to accommodate real shocks would in normal circumstances be made only once a year, or at most quarterly. But if the IMF Council identified some event with a major impact, such as an oil price increase, revisions could be made immediately.

Q Dr. Chun Pyo Lee (Professor, Seoul National University)

I would like to know about the operational aspect of the central rate and fitness of the band. I wonder whether you can illustrate in detail the factors which will determine the fundamental rates and also offer a little bit more explanation on why the band is 10%. In addition, I would like your opinion on the external factors that affect central rates for the non-member countries like Korea.

A Dr. Williamson

There are hundreds of pages written on this topic, and basically there are four or five different approaches to this issue. If you do not like my approach, using internal and external balance as a starting point, there is a certain amount of scope for variation, although the underlying theoretical concepts are similar. The biggest differences among my colleagues who have joined me in a recent book on this topic (*Estimating Equilibrium Exchange Rates*, published by the Institute for International Economics) are in terms of determining the external balance targets. Jerome Stein has a paper in which he essentially allows econometrics to determine the external balance target, which amounts to taking the *actual* capital flow of a country and asking what exchange rate is necessary to achieve it. But I think in one way or another it is

essential to make sure there is a sustainable set of balance of payments positions for the world as a whole that are compatible with the targets being assigned to the main industrial countries. On the issue of why 10%, the answer is simple: it is a nice round figure. If I said 8%, people would imagine that I really had some basis for knowing it should be 8% rather than 9%. A figure of 10% says that the appropriate band is more than 5% and less than 15%, which is something I feel comfortable asserting.

Q Dr. Hyo Koo Lee(Professor, Sogang University)

How do you see the equilibrium yen-dollar exchange rate?

A Dr. Williamson

To illustrate the range of uncertainty in this type of exercise, let me mention how my estimates of the equilibrium yen-dollar rate changed over the course of the 1980s. My first estimate, which referred to 1983, was just over 200; my most recent estimate, which referred to 1990, was little over 120—something like a 40% decline. I then asked how much of that decline could be explained in terms of the underlying theory, which recognizes a series of factors—oil prices changes, differential growth rates and income elasticities of demand, productivity bias, and asset accumulation—as being relevant. In that particular case almost all the change was readily explicable, which is reassuring. I am not claiming that all my other estimates came out equally close!

Q Mr. Jai-Woong Lee (President & CEO,
Coryo Research Institute)

From an effective implementation point of view, how does a target rate zone differ from the existing wider band reference zone system?

A Dr. Williamson

When they moved to “reference rates”, the G-7 didn’t want to adopt our terminology and so they picked their own! But there are also important differences of substance. In particular, we have always urged making the zones public, whereas the G-7 governments have always wanted to keep the zone secret because they thought that gave them a tactical advantage in the exchange market. But if the zones encompass the range of possible market equilibria, why not offer information to replace misinformation in the market? It’s only when countries are in danger of defending a disequilibrium exchange rate, as happened under the old-fashioned idea of locking oneself into an exchange rate until the market makes it impossible to stick with it any longer, that it makes sense to refuse to let the market know what the target is.

In fact, if a target is picked rationally, then there are all benefits and no costs in telling the market what the zone is. In a well-operating target zone system, a central bank wouldn’t have to intervene; the market would defend the zone. There were times when that happened in the EMS. There was a period when the EMS was working well and established a lot of credibility, and so there was little need for the authorities to intervene in the market: the markets supported them. Indeed it is happening again now.

The franc has moved backed to its old narrow band with no help from the French authorities, who left the task to the market.

Q Dr. Il SaKong (Chairman & CEO,
Institute for Global Economics)

As you know, Koreans today are in the process of opening up their financial/capital markets. The daily volume of global foreign exchange transactions is over 1 trillion dollars. Compared to our GNP size and our financial market, the size of financial flow seems to be proportionately too large. What kind of advice would you give to the Korean policy makers and people in the financial sector?

A Dr. Williamson

The problem Korea has been confronting recently is likely to become even greater under some of the provisions of the Uruguay Round on financial services. The problem of excessive capital inflow has arisen in recent years in a number of countries. In Latin America, after the debt crisis was over, there was a surge of money flowing back—partly capital repatriation and partly lending to the region, which took off much more quickly than expected. For the last two or three years, the typical problem in Latin America has not been the inability to tap the international market, but an excessive capital influx. So, these countries had to ask themselves the same question Korea is asking: how do you deal with an excessive capital inflow? The country in Latin America that has dealt with it most effectively is Chile. It has not allowed its exchange rate to become seriously overvalued. It has not tried

to block all capital inflows. Instead, Chile adopted a combination of policies. It has maintained and even strengthened some exchange controls, and imposed negative interest rates on foreign bank deposits, it has liberalized capital outflows by pension funds, it has gone to a wider band for the exchange rate so as to create a possibility that the currency will depreciate from the ceiling of the band and impose a capital loss on holders of the Chilean currency, it has also allowed a limited appreciation of the band (but not so big as to destroy the competitiveness of the external sector), and it tried to tighten fiscal policy and cut interest rates. By combining a series of measures of this type, Chile has come through relatively well.

Some of the other Latin American countries have in contrast allowed their currencies to become significantly overvalued on account of capital inflow. I worry about Argentina and Mexico, two countries in which capital markets are doing splendidly but the currencies are overvalued. In Korea's case, I would advise looking at a similar menu of measures as Chile took to limit the capital inflow.

Q Dr. Chong Man Kim (Research Fellow,
Korea Tax Institute)

Your target zone would be revived according to price differences, and we know that price change is much stiffer than other economic variables. Future price change can be predicted much more precisely. That means that the target revision would be expected. What about speculative attacks based on the prediction?

A Dr. Williamson

There is a probability that such a revision will be anticipated by the markets, but I don't think that this is anything to worry about. If one is devaluing to offset an inflation differential, then one in any event needs to have a higher nominal interest rate to compensate holders of domestic currency. The real interest rate need not be affected, so one does not need to worry about any speculative problem in the foreign exchange markets. The other sort of danger people point to in a policy of devaluing in accordance with the inflation differential is that you solidify the differential. This policy of passive accommodation of inflation means that one is ceasing to resist inflation. The conclusion I draw is that this is a policy that should never be undertaken in isolation. Some countries have tried to make the exchange rate anchor the center of their macroeconomic stabilization policy. They cannot do that in this type of system. Countries must have an internal anchor for the price level. They must have a monetary policy that is dedicated to price stability, and preferably a responsible fiscal policy as well, or a combination of tight monetary and fiscal policy. To my mind, too many countries seem to believe that central bank independence is the concern of the central bank and nobody else has to worry about inflation. That is a mistake. The proper way to control inflation is to have a combined monetary and fiscal policy to provide an internal anchor. Such complementary policies are required in conjunction with the exchange rate policy we are proposing.