

## The Global Exchange Rate Regime & Implications for East Asian Currencies\*

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Several years ago, a common view was that countries were being driven inexorably to one or other of the two polar exchange rate regimes that are customarily analyzed in economics textbooks, either firmly fixed exchange rates or freely floating rates. This so-called “bipolar view” lost popularity with the wreck of the Argentine economy at the end of 2001, as most economists drew the conclusion that the benefits of increased credibility through use of a currency board were outweighed by the increased costs of devaluing if in the end that should prove necessary. Admittedly a few have drawn a different conclusion: that currency boards are themselves one of those half-baked intermediate regimes that supposedly generate crises, and that choice should be confined to dollarization/euroization or free floating. But most economists were really floaters anyway, and used the occasion of the Argentine tragedy to urge the benefits of virtually universal floating. The word “virtually” is inserted to acknowledge that all but the most committed floaters can see some logic in, for example, European Monetary Union or dollarization in El Salvador.

I share the view that there are circumstances in which complete suppression of exchange rate flexibility can be advantageous. Some years ago I laid out the four conditions that I perceived had to hold for this to be true (Williamson 1991, pp. 395-96):

1. That the economy be small and open, and thus satisfy the conditions for an optimum currency area;
2. That the bulk of its trade is conducted with the trading partner(s) to which it plans to peg, so that its effective exchange rate is not subject to undue disturbance by fluctuations of the currency to which it pegs;
3. That the country is comfortable with an inflation rate consistent with that in the country to whose currency it plans to peg;
4. That the country is prepared to adopt institutional arrangements (such as a currency board or an independent central bank committed to the fixed rate) that will assure credibility of the fixed rate commitment.

In the absence of all those four conditions being satisfied, I too think that countries should float, at least in the sense that they should not have any obligation to defend a particular exchange rate. This is because in recent years we have observed cases of countries that tried, but failed, to defend what looked (*ex ante* and *ex post*) like perfectly reasonable exchange rates.<sup>1</sup>

But to argue that they should not have an obligation to defend any particular exchange rate is not the same as to argue that they should be indifferent to the level of

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<sup>1</sup> Perhaps the most compelling examples are Indonesia and Malaysia in 1997.

their exchange rate. The fact is that for most countries the real effective exchange rate is the most important relative price in the economy. I continue to believe that countries should think about the desirable level for their exchange rate; that there should be an international mechanism for approving a mutually-consistent set of target exchange rates; and that countries should take policy actions designed to limit the deviation of market rates from target rates. In the first part of this lecture I intend to elaborate on, and attempt to justify, these three assertions. The second part of the lecture discusses what I see the analysis as implying for the current values of the East Asian currencies, most particularly the Chinese renminbi and the Korean won, and consequently for desirable policies by these countries.

### **Why Worry About the Exchange Rate?**

Even if one agrees that the exchange rate is the most important relative price in the economy, this does not in itself establish that the government should concern itself with the value of the exchange rate. If the market really set the exchange rate at the “right” level, as happened in the pre-asset market models of exchange-rate determination (and is still assumed unthinkingly by many advocates of floating), then the way to get the right exchange rate would indeed be to leave it to the market. The case for managing exchange rates rests upon the view that the market often gets exchange rates seriously wrong.

This is most obvious during crises. Remember that the Korean won fell to a value of 1,967 to the dollar on December 23, 1997. The Indonesian rupiah fell to a minimum of 16,475 to the dollar on June 17, 1998, and now stands at 8,352 as this is written, despite substantial inflation in Indonesia in the interim. Until the bankruptcy of LTCM relieved the speculative pressures that were causing havoc among a number of the smaller currencies in September 1998, the Australian and New Zealand dollars, and the South African rand, were ridiculously undervalued. The Brazilian real fell almost to 4 reals to the dollar during the Brazilian panic last year, and has since recovered to around 2.85, despite intervening inflation and intervention designed to limit its appreciation.

However, one should not make too much of what happens during crises, because attempts to limit the depreciation of a currency once a crisis has really taken hold are of questionable utility. It is more relevant to note how large misalignments sometimes are in non-crisis times. Consider, for example, the dollar/euro exchange rate. At its trough in late 2000, the euro was worth less than 85 US cents, whereas now it has returned to a value close to that at which it was launched at the beginning of 1999, namely around \$1.17. There was no major change in the world that could justify any significant exchange rate change between these dates. How large a misalignment occurred depends on just where the equilibrium rate lies, but the lowest misalignment consistent with these figures is about 16 percent—the figure that is implied by both the extreme values if the equilibrium dollar/euro rate is the midpoint of the range, i.e. \$1.01 to the euro. (My own view is that the maximum misalignment was more like 40 percent, reflecting an assessment that the dollar/euro equilibrium rate is more like \$1.20 to the euro.) Variations in the yen/dollar rate have also covered a range of 40 percent even if one

disregards relatively short periods when the yen went outside that range. It is unambiguously clear that floating rates often float to levels far from any meaningful concept of equilibrium.

Does it matter if exchange rates spend a long time far from equilibrium? The classic view was that the resulting exchange rate volatility would have a cost in terms of lower trade. After the move to floating rates, there developed a large literature that sought to examine whether this cost could be empirically measured. Although some studies claimed to find some negative impact of exchange rate volatility on the volume of trade, the standard conclusion was that any such negative impact was small. However, recent work has tended to conclude that moving to the extreme of permanently fixed rates can be expected to have quite a big impact on the volume of trade; for example, the UK Treasury study of the impact of Britain joining the euro concluded that this would ultimately produce an increase in the volume of trade between Britain and present-day Euroland of around 50 percent.

Other studies looked at the impact of exchange rate volatility on investment. Rather surprisingly, these studies were considerably more likely than those on trade to find a negative effect of exchange rate volatility.

Nevertheless, these studies are essentially seeking to examine the impact of exchange rate volatility, rather than misalignments. The impact of these has been much less widely studied, perhaps because they are less susceptible to objective quantitative measurement. (Any measure of a misalignment requires a figure for the equilibrium exchange rate, and views on where this lies are notoriously prone to differ.) My earlier study (Williamson 1985) identified these costs analytically, even though it did not attempt to measure them, as follows: (1) The lower welfare resulting from consumption that varies from one period to another as a result of trying to stabilize output at full employment when the trade balance is changing as a result of a varying exchange rate; (2) The adjustment cost of moving resources back and forth between the tradable and non-tradable goods industries as the exchange rate changes; (3) The frictional unemployment that results when resources are switched between tradable and non-tradable goods industries; (4) Ratchet effects on inflation that occur if depreciation produces a bigger inflationary impact than the disinflationary impact of an equivalent appreciation (though most economists would probably dismiss this today in a way that they might not have done in the 1980s); (5) The protectionism that is generated by an overvalued currency as the tradable goods industries find themselves unable to compete internationally on a level playing field.

The costs of misalignments might in fact be greater than implied by this taxonomy if macroeconomic policy does not adjust ideally to counteract the impact of the exchange rate on output. For example, an overvaluation will lead to cyclical (not just frictional) unemployment if it is not counteracted by expansionary macroeconomic policy. In a recent paper (Williamson 2003) I also argue that economic growth can be threatened by a misaligned exchange rate. If the currency is overvalued, the incentive to invest is undermined because the tradable goods industries cannot compete internationally. If the currency is undervalued, growth is threatened by a shortage of

savings as excessive resources are diverted into accumulating reserves, which means making low-interest loans to the US Treasury, instead of investing in productive assets at home.

Hence I contend that where its exchange rate lies is a matter of critical importance to every country.

### **Internationally-Agreed Targets for Exchange Rates**

If countries think about where their exchange rate ought to be and decide that they cannot rely on the unaided market to set the exchange rate for them, then they will have a target for their exchange rate. But exchange rates are inherently two-sided; if one currency depreciates, then there must be some other(s) that appreciate(s). If countries pursue contrary exchange rate objectives, they are asking for trouble: inconsistent intervention that hands taxpayer money to currency speculators, and diplomatic or even general national enmity. How can this challenge be met?

One possibility is to have one country that stands outside the normal rules and allows its exchange rate to be determined as a residual rather than worrying about achieving a target. At times the United States behaves as though it is that special country, and treats the dollar's exchange rate with "benign neglect". The necessary corollary to this is for other countries to guarantee that they will always hold the volume of dollars that are pushed outside the United States by this behavior, and will never join a run to dump dollars in favor of some other currency. This is the Dollar Standard solution. There is something to be said for it. But we should be clear that this is only intermittently the policy of the US government. When the US Treasury Secretary starts pressuring other countries to appreciate their currencies, he is saying that the United States is not willing to treat the dollar's exchange rate with "benign neglect". And even when the Treasury Secretary is willing to accept a Dollar Standard, there are other actors on the US political scene (like Congressmen from districts with important export interests) who are appalled by the possibility. Add to that the fact that the rest of the world seems quite unprepared to guarantee never to dump dollars in favor of some other currency, and this solution does not look promising.

The other approach is to have some international authority that will be responsible for the development of mutually-consistent exchange rate targets that countries would accept. That authority should clearly be the International Monetary Fund, which has accumulated a great deal of experience in this area and enjoys almost-universal membership (North Korea, Taiwan and Cuba now being the only significant excluded countries). The issues are how it should go about calculating exchange rate targets and whether it could be expected to succeed in establishing a set of targets that all countries would be prepared to accept.

The key to the second issue is to develop in abstract an approach that is intellectually compelling. If presented by a set of target exchange rates before they have bought into the underlying intellectual framework, countries will naturally focus on how the proposed solution compares with what they were currently tending to regard as

nationally advantageous. But there is a chance that they can be brought along by the force of analysis, if indeed it makes sense.

In an attempt to demonstrate the feasibility of this, we developed a set of what I called “fundamental equilibrium exchange rates” (FEERs) in a series of papers that the Institute for International Economics has published over the years (Williamson 1985, 1994; Wren-Lewis and Driver 1998). Being a small research institute rather than commanding the large resources of the IMF, we focused on a limited range of currencies, basically the G-7 or even fewer. This was enough to illustrate the principles of interdependence involved, but nowadays it would be unrealistic to think that balance of payments adjustment could be determined exclusively on the basis of the G-7 currencies (see the discussion in Bergsten and Williamson 2003). A whole range of Asian currencies—the Chinese renminbi, the Hong Kong dollar, the Indian rupee, the Indonesian rupiah, the Korean won, the Malaysian ringgit, the Singapore dollar, the New Taiwan dollar, and the Thai baht, as well as the Japanese yen—are now systemically significant, and must expect to figure in future adjustment exercises. Such is the price of success.

The basic characteristic of the FEER is that it is that (real, effective) exchange rate that is consistent with domestic full employment (or non-inflationary growth, or sustaining the target inflation rate, however you want to specify the domestic macroeconomic objective) as well as with a satisfactory balance of payments outcome in the medium term. The key to establishing international compatibility of the target exchange rates is to have a set of internationally consistent objectives for medium-term balance of payments outcomes that are fed in to an appropriate econometric model linking current account outcomes to activity levels and real exchange rates. The set of exchange rates that come out of the model will then necessarily have the property of global consistency.

The process of establishing medium-term current account objectives can be illustrated by describing how Molly Mahar and I picked a figure for the Korean target when we offered a set of figures for global current account targets as an input to the calculation of FEERs in Wren-Lewis and Driver (1998). We first discussed the various factors that economic analysis suggests might influence the current account balance (which is the obverse of the net capital flow): the intertemporal model of international investment, the debt cycle model, demographics, generational accounting, the impact of growth on savings, the desirability of avoiding debt crises, and similarly the desirability of avoiding Dutch disease. We then analyzed what adjustments needed to be made to the published current account balance to get a “true” figure for the change in Korea’s net real indebtedness to the rest of the world. In principle we allowed for a share in the global current account discrepancy, for inflation bias, and for capital gains, although in practice in the Korean case we reduced the average published deficit of 1.3 percent of GDP over 1990-94 by a mere 0.2 percent of GDP (to allow for inflation bias, which meant that a part of the interest paid on Korea’s debt to the rest of the world merely offset dollar inflation rather than adding to Korea’s real debt). We argued that it was quite logical for the countries of developing East Asia like Korea (except maybe for Hong Kong and Singapore, which have now caught up with developed country living

standards) to have current account deficits. However, forecasts of savings and investment that we examined suggested that Korea was likely to have a current account surplus (as indeed it did). In the end we suggested that these two factors counterbalanced one another, and that an appropriate target for Korea would be (true) current account balance (implying a trivial published deficit of 0.2 percent of GDP).

If the intention was that countries were to be pressured to precisely achieve their current account targets, or punished for missing them, then I could understand that it would be a matter of great importance to a country as to precisely what target it was assigned. This would mean that there could easily be serious international disputes that would impede agreement on such targets. But, to anticipate what I will argue in the next section, the obligation that would go with a target is a promise not to intervene in a direction that would push the exchange rate away from the level estimated to be consistent with the target. If the won were weaker than its reference rate (or monitoring band), then Korea would be expected to avoid buying dollars, or taking other acts to weaken the won, but it would not be required to take actions to strengthen the won, such as selling dollars. This hardly seems such an onerous obligation as to rule out the possibility of reaching international agreement on a set of targets derived in this way.

### **Actions to Manage Exchange Rates**

The obligation that I would see as accompanying an agreed set of target rates would, as just indicated, be essentially a commitment not to take actions designed to push the exchange rate away from the target rate. The literature contains two versions of the way in which such an obligation might be formulated. The “reference rate proposal” envisages countries committing not to push rates away from the reference rate, which would be the agreed target (presumably expressed as a real effective exchange rate, which would be frequently translated into a target for the rate against the intervention currency in the light of third-currency exchange rates and differential inflation). The “monitoring band” proposal envisages each country declaring a monitoring band for its exchange rate within which it will not take policy actions designed to influence its exchange rate. When the currency is stronger than its monitoring band, it would be entitled—but not obliged—to take action to weaken its currency. Similarly, when the currency is weaker than its monitoring band, it would be entitled—but not obliged—to strengthen its currency. Both a reference rate and a monitoring band imply an obligation in the form of a commitment to abstain from intervention or other action to influence the value of the currency except when in support of an internationally approved objective (of pushing the exchange rate toward an internationally sanctioned value). The monitoring band is the stronger commitment, because intervention or similar action is proscribed not just up to the value of the target but for some distance each side as well.

What do I mean by “similar action” to influence the exchange rate? There are a series of instruments that a government may choose to use: changing domestic interest rates, requiring government-controlled financial institutions (such as the postal savings system) to switch their deposits from commercial banks to the central bank, altering the currency composition of its borrowing, imposing capital controls such as the unremunerated reserve requirement that Chile required foreign investors to pay in the

1990s, and levying taxes that might alter the incentive for foreign investment (e.g. imposing a tax surcharge on interest paid on debt denominated in dollars or other foreign currencies, so that a foreigner who wanted to lend to Korea would face a tax surcharge unless he were prepared to lend in won). None of these are guaranteed to be enormously potent, and most have disadvantages if pressed to excess, but collectively a willingness to use such instruments means that a country need not be condemned to watch its exchange rate float off to a crazy level without any ability to take counter-action.

So essentially the strategy to manage exchange rates has three elements. First, publish a set of mutually consistent target exchange rates. Second, allow countries to use sterilized intervention to discourage rates from wandering far from those targets. Third, in extreme cases encourage the back-up use of one or more of the range of instruments outlined in the previous paragraph. Many economists will doubtless sneer at such an approach and declare all the instruments either ineffective (which they would say about publication of targets and sterilized intervention) or undesirable (which they would say about capital controls and tax incentives). I leave to them the problem of reconciling the market's intense interest in whether the United States has really abandoned the strong dollar policy with this faith in the market *uber alles*.

In summary, the exchange rate system that I would like to see is one in which, with the exception of regional arrangements where the conditions for exchange rate fixity are met, exchange rates float. They float, however, in the sense that there is no obligation to hold them at any specific level, rather than that it is good international behavior for a government to pretend that it does not care where its exchange rate is or pretend itself incapable of developing a more farsighted view than the market of what exchange rate is good for the country. The IMF's central mission should be developing an agreed set of target exchange rates, which countries would accept either as reference rates or as the central rates of monitoring bands. Countries would be permitted, and might be encouraged, but would not be obliged, to encourage rates not to deviate too far from those targets by means of sterilized intervention and, in extreme cases, by additional measures such as unremunerated reserve requirements.

### **Implications for East Asian Currencies in 2003**

Suppose that this framework had been accepted by the international community. A key part of it is the agreed set of target exchange rates. In view of recent controversies, it may be of interest to consider what sort of implications would be likely to arise for some of the East Asian currencies. I will pay particular attention to the Chinese renminbi and the Korean won, because the former is clearly of key importance to the whole region and the latter is of special interest to this audience.

The first column of the table lays out the September 2003 IMF forecast of world current account balances in the year 2003. The dominant feature is, of course, the massive current account deficit of the United States, amounting to over 1 percent of GWP and around 5 percent of US GDP. If the world were securely on a Dollar Standard, so that the rest of the world was locked into holding on to those dollars unless it decided

to spend them on American goods and services, one could perhaps view such a deficit and the attendant buildup of US debts with equanimity. But that is not the world we live in: instead, present trends create the possibility, some of us would say likelihood, that at some stage a run will start from the dollar into some other currency, presumably the euro. A central objective of the adjustment process has to be to minimize that risk. This in turn means that the ratio of foreign debt to GDP in the United States has to be at least stabilized, and preferably to begin some decline.

| <b>Current Account Balances (billion US\$, 2003)</b> |                     |               |               |
|--|---------------------|---------------|---------------|
|  | <b>IMF forecast</b> | <b>Target</b> | <b>Change</b> |
| <b>US</b>  | -553                | -276          | 277           |
| <b>Euro area</b>                                     | 62                  | 0             | -62           |
| <b>Japan</b>   | 121                 | 121           | 0             |
| <b>New Industrial Economies</b>                      | 76                  | 0             | -76           |
| <b>Other Advanced Economies</b>                      | 49                  | 0             | -49           |
| <b>Advanced Economies</b>                            | -245                | -155          | 90            |
| <b>Africa</b>  | -4                  | -8            | -4            |
| <b>China</b>   | 19                  | 0             | -19           |
| <b>Other Developing Asia</b>                         | 23                  | 0             | -23           |
| <b>Middle East</b>                                   | 41                  | 22            | -19           |
| <b>Western Hemisphere</b>                            | -14                 | -21           | -7            |
| <b>Developing Economies</b>                          | 66                  | -7            | -72           |
| <b>Economies in transition</b>                       | 10                  | 0             | -10           |
| <b>Discrepancy</b>                                   | -170                | -162          | 8             |

*Source: Column 1, World Economic Outlook, September 2003. Columns 2 and 3, see text*

I present my adjustment scenario in column 2. This assumes that the objective of adjustment should be to halve the published US deficit, and then asks how that adjustment should be spread around the rest of the world. My answer is based on the following principles: (1) For surplus countries or regions without a specific reason for maintaining the surplus, take a target of current account balance. (2) For Japan, accept that the government is unable to expand internal demand, and therefore needs to maintain its current account surplus at its present size as a prop to demand. (3) For countries or regions in deficit, take the IMF prediction of their current account balance in 2004 as the target. (This makes sense only if those predictions are small enough to be consistent with prudence, but as it happens they are.) (4) For the Middle East, treat it in the same way, on the ground that some of the oil exporters of the Middle East should



save by running current account surpluses when oil prices are relatively high, as they are now, so that the region should not be expected to adjust away the whole of its current account surplus.

This procedure assigns a target of current account balance to both China and the new industrial economies, of which Korea is one. Japan, in contrast, is permitted to maintain its current account surplus. That is a reflection of the failure of Japan to stimulate its economy by expanding internal demand; it is not something that any other country should wish to emulate. Korea has not lost the ability to grow by stimulating domestic demand; it has the ability to play a full part in international adjustment, and not be a free-rider like Japan. China is an even clearer case in point than Korea. It not only retains the ability to stimulate domestic demand, it currently has domestic demand growing at a rate that is threatening to produce severe disturbances, perhaps taking the form of a resumption of inflation, in the economy. Worse still, its reserve acquisitions are fueling a growth in the monetary base and thus a financial bubble. It has a substantial capital inflow and large accumulated dollar reserves on which it earns a derisory interest rate compared to the rate of return to be expected from absorbing more real resources in the domestic economy. Korea can afford to revalue; China will positively benefit by revaluing. It probably ought to be aiming at current account deficit rather than the zero balance exhibited in the table, at least of around 1 to 2 percent of GDP (say \$12 to \$25 billion per year).

How large would the revaluations needed to move Korea to current account balance and China to a deficit of 1 or 2 percent of GDP be? This is a question for a macroeconomic model, and at present the Institute for International Economics does not have access to a satisfactory model for answering such a question. However, our Director has offered an answer on the basis of less formal calculations (Bergsten 2003), and his estimates are of an order of magnitude that looks plausible to me. He suggests that it would need a renminbi revaluation of some 20-25 percent against the dollar and a won revaluation against the dollar of around 10-15 percent. Note that these are revaluations against the dollar; if they took place as part of a concerted East Asian move for all the countries of the region to play a role in the adjustment process, they would involve substantially smaller changes in effective exchange rates. (Note also that Japan would still be expected to revalue against the dollar as a part of the adjustment, even if its current balance target remained unchanged, because keeping its dollar rate constant when other East Asian currencies—which collectively comprise 44 percent of Japan's effective exchange rate—revalued would induce an effective devaluation and thus result in a larger current account surplus.)

### **Concluding Remarks**

**I**n my lecture today I have aimed both at giving you an idea of the sort of international exchange rate regime to which I would like the world to move, and of the implications that such a regime would have for the renminbi and won. I am not, to be honest, particularly optimistic as to the prospect of the world moving away from the essentially unmanaged floating of the present day toward the managed floating that I have described. But I think you would be kidding yourselves if you imagined that this means

that my remarks about the need for revaluation of the East Asian currencies could be ignored. The powers that be may not admit even to themselves that they are following the sort of logic I have tried to spell out, but I suspect they think East Asian countries are standing in the way of letting the market act on that logic. That is a grave sin to those who believe in the magic of the market.

## Questions & Answers

**Q** Is your monitoring band proposal similar to the French proposal for a 10-15 year target rate zone system?

Secondly, you mentioned central bank interest rate intervention in Korea. I do not believe it would be effective. Korea used to follow a multi-currency floating basket rate system. But your organization and other US investors in Korea, all push for a US dollar peg system. However, with such a system interest rate intervention would not be effective. Please comment.

**A** The monitoring band is not the same as the target zone. I did go through a phase when I advocated target zones. But the difference between the two is that the target zone says you must not let the rate go outside the target zone. There's a firm obligation to intervene when you get to the edge of the band. A monitoring band is a looser system. It simply says that you must *not* intervene until you get to the edge of the band. At the edge of the band, you can intervene if you want to but you are not *obliged* to. It is a much looser obligation than the target zone system.

There was a period when I suggested target zones should have soft buffers. If you hit the edge of the band and concluded there were strong market pressures, you could allow the rate to go outside, but then you would have to bring it back in over time. There are all sorts of variations of this type that one can have. But the fundamental difference is that the monitoring band is a looser system.

Incidentally, the monitoring band proposal was first floated in a report to the Indian government on capital account convertibility. But it reported two months before the East Asian crisis broke. It urged India to move toward capital account convertibility over three years. Of course, given the East Asian crisis, nothing much more has happened since.

You also asked about the effectiveness of intervention. That is an open question. There is a great deal of debate in the literature as to just how effective intervention is. For a long time, it was assumed there were only two channels through which intervention could work, either by changing portfolios or by signaling what the government was going to do and how the central bank was going to change monetary policy.

Then it occurred to people that maybe there is a third channel. This seems to me to be the most plausible, to give information to the market. Traders, by and large, don't

have a long time horizon. To a trader, a long time horizon is about 24 hours. To a government, a long time horizon is about 24 years. One really needs to think about much longer term issues. So it may be that publication and intervention are ways of injecting additional information into the market as to what those longer considerations that don't normally figure into traders' calculations would be.

If traders are given that sort of information for free, you can't assume it won't have an effect on their calculations. It may not be worth their effort to calculate it themselves, but that doesn't mean that if they're given it for free it won't have an effect. That's the channel through which I suspect intervention, and also publication, can have an effect. We still have to see how, in the end, the results of intervention come out. But at the moment, everyone reads into those results what they want to read. They are not sufficiently unambiguous to have settled the issue one way or the other.

**Q** I do not believe that a 20%-25% appreciation of the Chinese renminbi would be effective. They have an abundant supply of low-wage labor, and they could improve their price competitiveness even if they appreciate their renminbi against the dollar. Also, their interbank trading volume is only US\$ 500 million, a very small amount. Under such circumstances, I doubt the US trade deficit would drop if there were to be an appreciation. What do you think?

**A** There is clearly a lot of labor still to be absorbed in China. Nobody doubts that. But it's a question of getting it absorbed in a productive way and with a sensible ratio between tradable and non-tradable goods. At the moment, too much labor is being absorbed into the production of tradable goods. This makes life very difficult for the rest of the world. I'm not thinking here primarily of the US. In fact, I don't think a renminbi appreciation of 20%-25% would have an enormous direct effect on the US balance of payments. The big impact—the big increases in Chinese exports—do not displace US production, but displace goods produced in other countries, primarily Southeast Asia and Mexico, and maybe Korea to some extent too. That is the really big challenge.

If those other countries on the Pacific Rim are to be emboldened to take part in an appreciation against the dollar, it is absolutely crucial that China go up as well. Otherwise, they lose competitiveness even more to China. I think a 25% appreciation of the renminbi would really make a difference in terms of slowing the rate at which Chinese production is displacing that of other countries. It wouldn't stop it in its tracks. I really don't think anyone wants to stop it in its tracks. It's part of a perfectly natural process. But it's also important that it doesn't happen faster than those other countries can move into producing other useful products so that they can also have full employment and growth.

**Q** You pointed out that reality is not matching theory these days. We just had the APEC meeting where US President Bush pushed very hard on the sidelines to encourage some adjustment in the renminbi and other currencies in East Asia, but with no result. In fact, it was left out of the APEC meeting's final statement. Are we in a non-sustainable situation? Are we in a situation where US debt and the over-valuation of the euro are going to force us to face a major adjustment?

**A** I think the administration really messed up when it asked the Chinese to abolish capital controls and float the renminbi. That is most definitely a prescription for disaster. Everybody knows the Chinese banking system is facing big problems. It has a lot of non-performing loans. There are enough Chinese households willing to take their money out of Chinese banks and put it in some other banks if given the opportunity. It seems to me, you just have to accept that.

Now, if that happens, two things would result. One, is that the renminbi might float *down* instead of up, which would make things worse from the point of view of the US. The other is that China might have a financial crisis, which really *might* stop Chinese growth in its tracks. It seems to me, therefore, that it was absolutely reasonable for China to reject what the Bush administration proposed. I'm *not* pushing the same thing as the administration.

Of course, the fact that the US administration even asked makes it even more difficult to do something reasonable. But one has to continue to talk about the advantages of doing what I regard as reasonable, which is a revaluation of the renminbi. Afterwards I'd like to see them go to a system with a basket peg and somewhat wider margins. That would be more like a target zone rather than a monitoring band. At the moment, I still think China is in a situation where the government is such an important actor in the market, that to float without capital convertibility really doesn't make much sense. It doesn't make much difference, either. One should allow China to build the sort of experience from which it will be able to eventually start floating.

**Q** I personally thought John Snow, the US Treasury Secretary, was irresponsible to push China toward a floating system, considering China's non-performing asset problem which may be 40%-50% of GDP and considering the very underdeveloped financial market and the lack of regulatory and supervisory structure. If you push China in that direction, it would be a disaster for China and the rest of the world. The Thai economy is very insignificant. But the Chinese economy is huge. What if China were to enter a financial crisis? The contagion would be so widespread! That's why I thought it was not right to immediately push China toward a flexible exchange rate. Bergsten is pushing a one-shot revaluation with all kinds of controls. That makes some sense. But in my view, 20%-25% will not occur in the near future, knowing Chinese policy. What do you recommend China do?

**A** I agree that Snow's proposal was irresponsible. I think the most irresponsible part was his comments on capital account convertibility and not floating the exchange rate. I don't think floating in itself makes an enormous amount of difference if you don't have capital convertibility, given that the government is the dominant actor in the market. It's really on the convertibility comments that I criticize the administration. I agree that, overall, the proposal was irresponsible.

In terms of how China should first move, I do think it would be a big mistake to do something very small. If they do something very small, they just accelerate the expected capital inflow they've been getting, which is at the root of the over-expansion

of the financial system that has been going on and that has been giving rise to a bubble. This would create a crisis down the road. They need to do something big enough in the first step to make sure that that stops. They don't want to give themselves the *other* problem. My reading is that they could easily absorb something like 20%-25%, but if they chose something slightly smaller, that might still work.

**Q** As you admitted, the global community is not ready to accept your proposal. But wouldn't it be easier if the G3 had some agreement on keeping exchange rate stability among the three key currencies? You and Bergsten proposed a recommendation in this regard. If the G3 were willing, it would be much easier to have an agreement by which they could keep some stability. Small open economies like Korea are so vulnerable because of these key currency exchange rates. When there's a huge adjustment, it is really difficult for small open emerging economies. If you have a choice, wouldn't you still push the G3 to adopt such a proposal?

**A** I think the core problem *is* the G3. If you could get Japan, the US and Germany, or the euro area, to agree, it would solve a lot of problems. If you got them to agree, it wouldn't be too difficult to bring the rest of the world along. But under the present administration in the US, the G3 will never agree to anything. Who knows, though? US presidents, and even treasury secretaries, sometimes make surprising changes in policy. Who knows what somebody may do at some stage in the future? That's where the real problem lies. The G3 are a lot less trade-dependent than other economies, so they are less vulnerable to exchange rate fluctuations.

**Q** Your presentation has been so logically presented, that we have to wonder why it hasn't been implemented by the world community. You, yourself, indicated your own pessimism as to the prospects of the world community moving on your proposal. We have to wonder why.

A fundamental difficulty arises from the fact that there is no way of setting an equilibrium level of exchange rates *ex ante* in a way that everybody would agree. You may have your own model, but somebody else will have their model. The two models could contradict each other. In the end, this notion of equilibrium exchange rates becomes a politically determined variable. The Chinese government has its own theory, and its own conclusions, as does each other government.

To cope with these differences, you propose to bring in the IMF as the final arbitrator. But I think you are proposing to make the IMF politically unsustainable. The political differences will continue to persist. I think that will be the case on the current discussion of the appropriate level of the renminbi.

My feeling is that the Chinese government would be very unwilling to accommodate a renminbi appreciation at this time. Suppose China tries to stick to its current renminbi policy for the next, say, two years. At the end of your presentation you made a very interesting remark, a vaguely veiled threat. You said, "you are kidding yourselves if you imagine my remarks about this can be ignored". But East Asian

countries will not listen to you. What is the disastrous scenario you have in mind? For what sort of shocks should we brace ourselves?

**A** When I was in the IMF, I found it intriguing to watch the interplay between technocratic and political factors. I could well see that people bring along different models. The IMF Executive Board might make one proposal, and then the countries would propose something different. The staff would then take *that* away and study it, only to propose something else again. They'd comeback and maybe they would make some more modifications in their proposals, or maybe assess another model, etc. At the end of the day, there might still be some sort of a gap, but it would be small. The way the IMF breached gaps when it got down to such politically irreducible minimums, was to split it. They agreed on the middle. I saw this many times.

The question at the time was about the interest rate on special drawing rights (SDRs). It was a direct conflict of interest between creditors and debtors. The creditors wanted the SDR rate higher, based on market interest rates. The debtors wanted it lower. Initially the rate was 0%, since the SDRs were supposed to be a new form of gold and gold was at 0%. Then the dollar yielded 3%, so they raised the SDR rate to half of that, 1.5%. Then the world interest rate went a lot higher. So they took the SDR rate to halfway between 1.5% and what the current market rate was. It went up in a series of steps to where it obviously had to be, which was at the market short-term interest rate.

So even when there was a direct conflict of interest between countries, there was a reasonable way of solving these problems if people thought they must be resolved. There had to be an interest rate on SDRs, otherwise the system would have ground to a halt. In the same way, I think you can arrive at an agreement on a set of exchange rates that would make some sense.

In terms of what I meant by my "veiled threat", I suppose the biggest danger is that protectionist forces will get their head. This administration does not seem as dedicated to free trade as some of its predecessors. It will not actually take the lead in advocating protection, but that is not to say it will be sufficiently resistant to such forces. If there is no movement on the exchange rate front in East Asia, I'm really worried about the way in which the administration might give in to protectionist forces. This is the sort of threat that the world does not need at this point.

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