Achieving exchange rate flexibility in China

Beijing has a lot to learn from the way S'pore and India have managed to successfully pursue a basket peg arrangement

By RAMKISHEN RAJAN

THERE is a growing belief that China will introduce greater exchange rate flexibility at some stage in the near future by replacing the current US dollar peg with one based on a basket of currencies. In other words, China may switch from targeting the bilateral exchange rate of the renminbi vis-a-vis the US dollar to targeting the trade-weighted or effective exchange rate.

In Asia, India and Singapore have been pursuing a basket peg arrangement for some time, and have done so fairly successfully. In particular, both have operated flexible Band-Basket-Crawl (BBC) arrangements. The parity ('basket') is determined on the basis of an undisclosed basket of currencies (major trading partners). Both countries also allow their currencies to vary within an undisclosed 'band' around the central parity as a means of ensuring greater exchange rate flexibility.

The broad objective of exchange rate policies in both countries is to balance two key variables - export competitiveness and imported inflation - while maintaining overall financial market stability. The BBC arrangement is thus viewed as a means to an end. Accordingly, neither country appears firmly fixed on the central parity, bandwidth or extent of crawl, any or all of which might be altered if so required by economic circumstances.

Following India's balance of payments crisis in mid-1991 until late 2001, the Reserve Bank of India (RBI) has allowed the rupee to trend downwards vis-a-vis the US dollar and other major currencies in order to account for persistently higher domestic inflation in India. This has ensured that, in real terms, the rupee has not been obviously misaligned. This is important as a persistently overvalued currency will hurt a country's exports and overall growth prospects, while a persistently undervalued one will lead to the build-up of inflationary pressures that may be hard to squeeze out painlessly.

Strong Sing dollar policy

The objective of ensuring that the real effective exchange rate is broadly aligned with overall macroeconomic fundamentals has also been the driving force behind Singapore's exchange rate policy. But unlike India, the Singapore dollar has been on an upward crawl (appreciation) until 1997-98. This upward crawl was a deliberate policy by the Monetary Authority of Singapore (MAS) to keep inflation under check. This so-called strong Singapore dollar policy was also a tool used to promote structural adjustment (to higher value-added, less price-sensitive activities). The strengthening Singapore dollar has also been a boon for Singapore investors looking to invest overseas (as assets abroad are relatively cheaper when valued in Singapore dollars).

While there have been some criticism about the overly deflationary effects of Singapore's strong dollar policy, it has served Singapore well and has lent credibility to
the MAS. Nevertheless, the policy was on an extended hiatus since the East Asian crisis. While the reasons for this are manifold, the three most significant ones were probably the sharp slowdown in the country's average economic growth post-crisis, the deflationary global environment, and sharply depreciated regional currencies.

However, indications of a broad-based, cyclical upturn in domestic economic growth, along with signs of a resurgence of inflation domestically and worldwide, provided the impetus for the MAS to revert to a policy of gradual appreciation of the nominal effective exchange rate in April 2004.

There is a broadly parallel and animated debate ongoing in India regarding the strength of the Indian rupee and the role of the RBI. The RBI has reversed its policy of allowing the rupee to crawl downwards since late 2001. In fact, the rupee has been gradually appreciating against the US dollar since May 2002 (at its trough, one US dollar was worth about 49 rupees).

Nonetheless, like most other Asian currencies, including the Singapore dollar, the rupee has depreciated sharply against other major currencies such as the euro and the pound. Attempts by the RBI to limit the upward pressures on the rupee are apparent by the rapid build-up of foreign exchange reserves in the last few years. India's stock of reserves doubled in less than two years and now stands at US$120 billion.

Accumulation of reserves creates liquidity in the domestic financial system with attendant inflationary repercussions. Like its other Asian counterparts, the RBI has, until recently, been aggressively 'sterilising' the inflationary pressures via the sales of government bonds (secondary issues).

In recent times, however, the RBI has been faced with a policy conundrum. Sustained contractionary open market operations to curb liquidity growth has depleted the stock of the RBI's government bonds. This, along with the RBI's understandable reluctance to use relatively costlier and far more blunt instruments like reserve requirements, implies that the sustainability of the RBI's sterilisation operations for neutralising the monetary impact of its forex intervention is in some doubt.

This problem has been overcome in other Asian countries by the central banks floating their own bonds or bills (primary issues). The RBI has decided against following this route for two reasons. One, if the central bank issues its own bonds, it would have to bear the costs of sterilisation (hence decreasing central bank capital). Two, issuance of central bank bonds may raise the risk premium demanded on government bonds (which tend to be perceived as riskier than those issued by the central bank), hence exacerbating the costs of raising much-needed finances by the government.

Instead, the RBI recently launched so-called market stabilisation bonds (MSBs), which are to be issued by the Government of India with the specific aim of absorbing the liquidity created in the financial system due to forex intervention. The proceeds of the MSBs will not add to the fiscal deficit as they are to be held in a separate non-interest bearing account called the Market Stabilisation Scheme (MSS) account which is to be maintained and operated by the RBI. The government cannot spend the money available in the MSS account except to pay back maturing debt. The MSS account will help improve the transparency of the RBI's sterilisation operations. India's East Asian neighbours should consider learning from the Indian experience in this regard.
While the MSBs have alleviated the physical constraints hindering sterilisation over the short and medium terms, the RBI chose to reduce its degree of intervention in the forex market in the last week of March 2004. The result was that the rupee appreciated sharply from over 45 rupees per US dollar to a near four-and-a-half-year high of 43.5 rupees per US dollar. This non-intervention by the RBI may have been for purely technical reasons - the first batch of MSBs only came on stream in early April. Thus, the rupee appreciation may have occurred because the RBI temporarily lacked the necessary ammunition to sterilise its forex operations.

This seems to be a reasonable conjecture as the RBI has since intervened in the forex markets to prevent the rupee from appreciating too rapidly relative to the US dollar. Thus, the rupee is currently back at the 45 rupees per US dollar level, but still far stronger than its trough of almost 49 rupees per US dollar exactly two years ago.

**Complex dilemma**

Whatever the exact reasons behind the Indian rupee's short and medium run appreciation, it holds important lessons for China. Assuming that the Chinese policy makers are convinced of the need to move towards a flexible basket peg, they are faced with a complex dilemma. On the one hand, too large a revaluation could retard export competitiveness in the short run and the domestic financial system may be unable to cope with a sudden change.

On the other hand, it is apparent that China needs to take more pro-active and assertive measures to cool its economy to avert a hard landing. Renminbi appreciation may be a way of doing so. Yet, too small a revaluation would continue to pull in inflationary quantities of foreign capital as markets continue to expect future revaluations (and therefore the possibility of large capital gains).

Thus, if China is to attempt a transition to a BBC arrangement in the near term, it should involve two stages - the renminbi should initially be revalued modestly and then repegged according to an appropriately weighted basket of currencies. Given China's concerns about exchange rate variability, it may want to initially begin with a fairly tight or narrow band, but widen the band over time as markets become more comfortable with a flexible exchange rate and financial markets develop sufficiently.

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