

Asian Currency Matters: AEA Meetings, Boston, January 7 2006
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**Comment on “China’s Exchange Rate Dilemma” by M. Goldstein and M. Lardy,
“Exchange Rates. “Wages and International Adjustment,” by R. McKinnon, and
“The Parallel Currency Approach to Asian Monetary Unification,” by B. Eichengreen**

I will comment briefly on all of the papers presented this morning, but I will devote much of my time to Barry Eichengreen’s paper, because it is closely related to my current work on monetary integration in various parts of the world.

Goldstein and-Lardy: I agree strongly with the analysis and recommendation offered by Goldstein and Lardy. In fact, I have made a similar recommendation – a fairly large revaluation followed by further progress toward full flexibility. Unfortunately, Chinese officials have been quoted recently as saying that they will allow only gradual appreciation of the RMB. But let me make three brief comments inspired by this paper.

First, the stance adopted by the US Treasury and the IMF, favoring an early move to floating rather than a once-for-all revaluation, is fundamentally inconsistent with the Articles of Agreement of the IMF. Under Article IV, each IMF member is entitled to choose its own exchange-rate *regime*, but the Fund is supposed to exercise “firm surveillance” over its members’ exchange-rate *policies*, with the aim of preventing those policies from obstructing the balance-of-payments adjustment process. In other words, the US Treasury and, more importantly, the IMF, should be making the case for a large change in the RMB-dollar exchange rate rather than the merits of floating *per se*. There is, to be sure, a strong case for floating, because it will enhance the functioning of monetary policy. But the emphasis on floating has handed the Chinese authorities a plausible excuse for moving far too slowly.

Second, Goldstein and Lardy argue persuasively that the undervaluation of the RMB encourages overinvestment in the tradable-goods sector, and they warn that it will reduce profitability in that key sector. If they are right, and I think they are, failing to revalue the RMB will affect the traded-goods sector in much the same way as a big nominal revaluation. In short, China cannot avoid a real appreciation; it has only to decide how it will occur – which bolsters the case for a large nominal revaluation.

Third, Goldstein and Lardy rightly warn that the present situation is unsustainable, but they say very little about the way that a crisis might erupt. While that was not the aim of their paper, it is, I submit, time to start thinking seriously about damage limitation. What should be done if the Chinese and others do not revalue their currencies and the US current-account deficit continues to grow?

Chinese officials have been quoted as saying that China will not engage in unilateral diversification out of the dollar – that diversification should be achieved in an orderly way within a multilateral framework. If that is true, it is surely time to start thinking about the design of such a framework, involving the US and European authorities, as well as the large dollar holders. I made some suggestions at last year’s AEA meetings, but they were rightly criticized as being

politically unrealistic. The problem, however, won't go away. It may indeed become more urgent. Shortly before today's meeting, China's central bank announced that it may begin to diversify by asset class and currency, without even mentioning coordination with other major reserve holders.

McKinnon: Having said that I agree with Goldstein and Lardy, you will not be surprised to learn that I disagree with McKinnon. Here, again, three brief comments, followed by a question:

McKinnon continues to favor the preservation of an Asian dollar standard, though that is not the main point of his present paper – which is instead an extended analogy between the effects of yen appreciation and the likely effects of an RMB appreciation. In several other papers, however, McKinnon has said that an Asian dollar standard must be shored up by an agreement between Washington and Tokyo to stabilize the yen-dollar rate. And if he is right about that, the Asian dollar standard is in deep trouble, because Washington and Tokyo are unlikely to take his advice.

In his paper today and several others, McKinnon explains that Japan's lost decade was due to the secular appreciation of the yen since 1971. That lost decade, however, was due in large part to the collapse of the Japanese real-estate bubble, imprudent lending by Japanese banks, and an ill-timed tax increase during a recession. Furthermore, the near-zero interest rate prevailing today in Japan is not, I submit, the endogenous reflection of exchange-rate expectations. It is a manifestation of the monetary policy pursued by the Bank of Japan. Note finally that a rather strong yen has not prevented the broad-based recovery now underway in Japan.

McKinnon's main point, however, is his warning that an appreciation of the RMB will do as much damage to China that the appreciation of the yen allegedly did to Japan. Yet this conclusion appears to be based on a dubious analogy between the two countries' labor markets. To put the point simplistically, McKinnon's history of Japan assumes implicitly that the Japanese labor supply was inelastic, so that productivity growth, which raised the demand for labor, led to rising wage rates. In China, by contrast, the supply of labor to the tradable-goods sector is very elastic indeed. Wage rates have risen in Eastern China, thanks to the growing demand for skilled labor by an increasingly sophisticated export sector. Yet China as a whole comes very close to resembling Sir Arthur Lewis' famous model of a developing country with an unlimited supply of labor at a near-subsistence wage rate.

Finally, my question: If future intervention by the People's Bank of China would cause a huge explosion of the monetary base and drive interest rates to zero, why hasn't that happened to date – in years when the PBOC has accumulated some \$200 billion of reserves per year for the last couple of years?

Eichengreen: Barry Eichengreen's paper discusses two ways to use an Asian Currency Unit (ACU) to foster financial and monetary integration in East Asia. The first is to use the ACU to unify and catalyze Asian bond markets. The second is to use it as the *numeraire* for an East Asian exchange-rate arrangement resembling the European Monetary System (EMS) and thus as a stepping stone to a full-fledged monetary union in the much longer run.

Yet Eichengreen notes that the European Currency Unit (ECU), introduced in the mid-1970s, was not widely used in Europe. It was used extensively by the official sector of what we call today the European Union, but it was not widely used by the private sector, even after 1979, when it became the unit of account for the EMS. I think it fair to say, moreover, that the EMS itself was not seen initially as a stepping stone to monetary union. Recall the famous phrase coined by its two godfathers, Helmut Schmidt and Valéry Giscard D'Estaing: The EMS was meant to foster a "zone of monetary stability" in Europe – to insulate intra-European trade and the Common Agricultural Policy (CAP) from the effects of exchange-rate fluctuations coming from the outside world. The move to monetary union got under way after the adoption of the Single European Act, which called for the abolition of all capital controls and thus threatened the viability of the EMS.

It should be noted, moreover, that trade within East Asia, although growing rapidly, is a much smaller fraction of total East Asian trade than is intra-European trade as a fraction of total European trade. It may thus be more useful for the East Asian countries to limit exchange-rate fluctuations *vis-à-vis* the dollar, euro, and yen than to stabilize exchange rates within East Asia.

This brings me to my main point – the importance of distinguishing between two sorts of currency baskets: an internal basket comprising the ASEAN currencies, the RMB, Korean won, and (perhaps) the Japanese yen, and an external basket, comprising the dollar, euro, yen and (perhaps) the RMB. (The RMB is not fully convertible, but that does not matter for this purpose, because stabilization *vis-à-vis* an external basket does not require intervention in each and every currency; dollar intervention would be sufficient.) There are two key differences between the two sorts of baskets:

1. Stabilization *vis-à-vis* an internal basket does not imply stabilization *vis-à-vis* the dollar, euro, yen, or RMB. Furthermore, it does not impose or induce the harmonization of its members' monetary policies. In the case of the EMS by contrast, there was *de facto* harmonization, because of the dominant role of the Bundesbank.
2. Stabilization *vis-à-vis* an external basket provides partial stabilization *vis-à-vis* the dollar, euro, yen, and RMB, while also achieving the partial stabilization of the participants' bilateral exchange rates. Furthermore, the link to the dollar, euro, and yen would foster the partial harmonization of the members' monetary policies insofar as their capital markets are open to the outside world.

It would thus seem to me that the use of a key-currency external basket is the more promising vehicle – the better way of moving toward monetary union if that is the long-run objective, the better way to achieve more exchange-rate stability within East Asia, and the better way to integrate the financial markets of the East Asian countries.