

Currency Decision Marks Small Shift Toward Flexibility; Move Follows Broader Embrace Of 'Floating Rate' Systems By Developing Countries; Using Singapore As A Model

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China took only a small step away from a rigidly fixed currency system yesterday. But its actions still marked a big step in the 30- year evolution of the global financial system toward more market- driven, flexible exchange rates.

Countries generally choose either a "flexible" policy for their currencies, allowing them to trade freely in often ruthless global financial markets, or a "fixed" approach, keeping the currency stable but losing control of other economic levers like interest rates.

China, mindful that painful tradeoffs come with either approach, is trying to chart a middle path. Using tiny Singapore as its model, it aims to allow some market flexibility while maintaining many government controls. In addition to moving the yuan up a bit, it said it would end the yuan's link to the dollar and instead let it trade in a narrow range tied to a "basket" of currencies -- with details of the currencies and their mix kept secret.

It also promised "greater flexibility," a suggestion that the target the government sets for the currency will be determined, at least in part, "based on market supply and demand."

The move ultimately could set China on a course traveled by many developing countries in recent years. Some 139 countries, most of them small, moved from fixed to flexible exchange rates between 1990 and 2002, according to the International Monetary Fund.

But it's been a painful ride for many of them, a history that is not lost on Chinese officials. Well over half of those countries made the switch under what the IMF delicately calls "disorderly" circumstances -- meaning financial or economic crises.

Argentina, for instance, which had long tied its currency to the dollar, abandoned the link in 2002 because the high interest rates then needed to sustain the currency's value were strangling the economy and banks. In the 1990s, other countries -- such as Mexico and Thailand -- were forced to abandon their dollar links when investors fled their markets and their banking systems, deprived of capital, melted down. Both countries were thrown into deep recessions.

The choice between a fixed-rate system and a flexible-rate system can be unappetizing, since both carry risks. Defending a fixed exchange rate -- under which a currency is set at a predetermined rate -- can force policy makers to push up interest rates to preserve their currency's value and possibly wreck their economies. A flexible exchange rate -- under which a currency's value "floats" against other currencies -- can absorb shocks, but also exposes a country's financial system to speculative attacks and sudden devaluations that can hurt an economy.

Some economists say a middle ground could carry even greater risks, because it opens a country's currency to market forces but leaves officials without all the tools to defend it. China, however, clearly is betting that it is in a position of strength in charting its own course, because of its huge financial resources and, importantly, because of government controls on the movement of capital in and out of the country.

"The world's largest developing economy has clearly gone down the route of the middle," said Jeffrey Frankel, a Harvard University international economist who worked in the Clinton White House. "This is not a country that is moving in the direction of a firm fixed [exchange rate] and it is not a country that is moving in the direction of a firm floating."

The global currency system has evolved significantly since a system of fixed-exchange rates among major economies was negotiated after World War II. The original goal of the victorious powers was to create a new world economic order that, they hoped, would avoid the chaos that followed the collapse of the gold standard in World War I and exchange-rate turmoil that contributed to the Great Depression. The system, known as Bretton Woods for the New Hampshire resort where it was negotiated, called for the U.S. and Europe to maintain fixed exchange rates, with some flexibility to make adjustments in times of economic crisis, under the watchful eye of the International Monetary Fund.

The Bretton Woods system ran into trouble in the 1960s, in part because U.S. trade deficits mounted and the nation lacked financial reserves to support the currency. It finally came unmoored in 1973, and most major currencies began floating against their counterparts. A number of Europe's major economies surrendered the ability to adjust their currencies against each other with the creation of the transnational euro in 1999. But the euro moves freely in financial markets against the dollar.

Developing countries were slower to make the move. Still, bound to the developed world by trade but often too small to navigate the global financial system safely, many have chosen or been forced to do so. In 1975, 87% of developing countries had some type of pegged exchange rate, according to the IMF. By 1996, the figure was below 50%, and it has continued to fall. Chile, Israel and Poland moved to flexible regimes gradually, while Turkey and Brazil made such moves more abruptly. Hong Kong stands out as an exception: Despite China's move, the Hong Kong dollar remains fixed to the greenback.

"Exchange-rate flexibility is extremely important as the economy keeps opening up," says Ramkishan Rajan, a visiting economics professor at the Lee Kuan Yew School of Public Policy in Singapore. A country with a fixed exchange rate essentially must buy its currency when foreign investors try to sell large amounts, in order to sustain its value. That can drain its foreign-currency reserves -- and push interest rates higher.

China's exchange rate has stayed stable, despite the gobs of capital pouring into the country, only because its central bank has bought billions of U.S. dollar assets, such as U.S. Treasury debt. Chinese technocrats and economic officials around the world saw its approach as unsustainable, in part because buying dollars for yuan made it difficult for China's central bank to manage the supply of credit internally.

China also has avoided another common problem for countries with fixed exchange rates. They usually run into trouble when economic and market conditions argue for a lower value and they can't do what's needed to prop up the currency.

China is in the opposite situation, with a currency that appears undervalued. That's a more comfortable problem to tolerate, but comes with its own share of possible pitfalls, inflation being one of them. China's controls on capital have been important in limiting, though not eliminating, the ability of citizens and speculators to put pressure on its currency, making it easier for the government to manage the currency than it is for countries where capital flows more freely.

Singapore adopted its basket approach in 1981, when memories of oil shortages, stagflation, and exchange rate volatility of the late 1970s remained fresh. It was seen as a halfway house between fixed and flexible currencies.

The advantage of a basket is that a currency isn't pulled way out of whack by sudden market moves, for instance when the dollar moves sharply against the euro, as has been the case recently.

It is known as a "managed float," meaning that the government doesn't let the markets set its value without limit, but doesn't try to maintain a fixed peg either. Especially in a smaller economy, a fixed peg can be broken when speculators bet billions against it, as several Asian countries learned in 1997. China has technically operated a managed float since 1994, but is now expected to allow more flexibility.

Singapore's approach, closely studied by the Chinese in recent months, has been an economic success: Per capita income has risen substantially, inflation has been contained and interest rates have stayed low, encouraging consumers to spend. Despite essentially open borders for goods and capital, authorities have managed to keep the Singapore dollar relatively stable, tolerating a slowly rising trend.

Singapore doesn't reveal exactly how its basket of currencies is constructed, an approach China appears to be emulating. Because they don't know which currencies are in the basket, market participants are kept off-guard, and are reticent to make big bets against the central bank. Slowly, the central bank can edge the exchange rate up or down -- a technique called a "crawl" -- rather than do it in one, big jolt.

While the model has worked well for Singapore, it's less clear that it can work for an economy as large as China's. Singapore's gross domestic product is only half as much as Wal-Mart's annual revenue. Moreover, because of its smaller size and the government's firm grip on power, Singapore's central bankers have a number of ways besides interest-rate moves to steer the economy that a larger country like China may not. For example, by tinkering with rules on how Singaporeans can use funds in their mandatory pensions accounts, the Monetary Authority of Singapore has in the past influenced prices in the housing market.