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Choosing an exchange rate regime during economic transition The case of China

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Abstract

The choice of an appropriate exchange rate regime during economic transition is investigated through the case of China's 1994 reform programme. Within a game-theoretic framework, the paper compares welfare under alternative policy regimes. While not upsetting government welfare, China's exchange rate unification through a floating rate has compelling benefits as a means of aborting the multiple practice. Given the choice of a flexible rate regime for convertibility, numerical simulations show a managed floater is favourable and may additionally mitigate the credibility problem associated with convertibility. Simulation outcomes also reveal China's policy preference is to place a higher weight on competitiveness than on inflation. © 2001 Elsevier Science Inc. All rights reserved.

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1. Introduction

The recent Asian financial crisis has shown that China's exchange rate policy is a matter of considerable international concern. Given the prospect of China's accession to the WTO, the importance of China's exchange rate policy is no doubt growing. It is then of interest to examine how China will respond to her accession to WTO membership. In this respect, what

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exchange rate regime China will choose is vital. In this paper, we examine the recent experience of China's reform of her exchange rate regime and, based on this, we analyse what determines China's choice of alternative exchange rate regimes.

In the literature, choosing an appropriate exchange rate regime has engendered considerable research interest. There are some general guidelines suggested in the literature. For an individual country, the choice depends on the properties of alternative exchange rate arrangements as well as on the country characteristics and the nature of shocks affecting the economy (Ghatak, 1995). Countries will typically choose to float their exchange rates if they have a large gross domestic product (GDP), a low degree of openness, a high inflation differential with other countries, a high degree of integration in international capital markets, and substantial diversification in traded goods (Heller, 1977; Holden, Holden, & Suss, 1979). Besides country characteristics, the nature of the stochastic shocks may also affect a country's choice of exchange rate regime. Boyer (1978) shows that, in models with only traded goods and money, it will always be optimal to follow a managed float if the economy is subject to both goods and money market shocks.

Williamson (1991) suggests that, when a country does not satisfy the following conditions for having a fixed rate system, a managed rate should be adopted. These conditions are: (a) the economy is small and open; (b) the bulk of its trade is undertaken with the country to whose currency it pegs; (c) the country wishes to pursue a macroeconomic policy that will result in an inflation rate consistent with that in the country to whose currency it pegs; (d) the real shocks to the economy should be synchronised with those in the country to whose currency it pegs; (e) the country is prepared to adopt institutional arrangements that will assure continued credibility of the fixed rate commitment. If a country does not satisfy all the above four conditions, a fixed exchange cannot provide a sensible policy regime.

Economic transition in China and other countries has brought new complications. In these countries, their exchange rate regimes had typically undergone a very complex evolution before the economic transition was launched. Then, in the reforming years, the exchange rate arrangements naturally become the object of reform and thereby the choice of an exchange rate arrangement often means the reform of the policy regime in the first place. On the other hand, their choice of an appropriate exchange rate regime is being made, while their economies are undergoing enormous structural change (Sachs, 1996). The reform of the exchange rate regime is usually a part of a wider reform programme, which may contain other tasks such as the merging of multiple exchange rates and moving to convertibility.

China's 1994 reform programme is a case in point. At the end of 1993, the Chinese Central Bank announced measures for advancing foreign exchange reform. With effect from the 1st of January 1994, they included unification of multiple exchange rates; adoption of a managed uniform floating exchange rate regime based on market supply and demand; abolition of the foreign exchange retention system and the introduction of a foreign exchange surrendering system; abolishing the compulsory foreign exchange plan, permitting end-users to buy foreign exchange from designated banks on presentation of valid import documentation; termination of the issuing of foreign exchange certificates