China's Quiet Revolution

***Why China's new, more flexible exchange rates may be a boon to the global economy.* By John B. Taylor.**

The recent policy shift in China from a pegged to a flexible exchange-rate regime starts a new chapter in international finance, comparable to the dramatic end of the Bretton Woods system of pegged exchange rates in 1971. Economists had dubbed the decade-long Chinese peg "Bretton Woods II" because many other countries in Asia kept their currencies close to the yuan and effectively tied to the dollar. Bretton Woods II is now over, but what is next?

In China, the new exchange-rate regime will enable the central bank—as it modernizes the financial system—to conduct monetary policy in much the same way as do successful central banks in large developed economies, including the Federal Reserve. Without the constraints of a rigid exchange-rate tie, the central bank of China will be able to adjust its interest rate enough to achieve its price stability goal. This will reduce the chances of overheating and hard landings, which have been a risk to the global economy. The more flexible exchange rate will also help bring about adjustments of trade imbalances by facilitating appropriate changes in the price of exports

John B. Taylor is the Bowen H. and Janice Arthur McCoy Senior Fellow at the Hoover Institution and the Mary and Robert Raymond Professor of Economics at Stanford University. He is a former undersecretary of the Treasury for International Affairs.

and imports. This, too, will reduce risks in the global economy. This benefit will be greater if other central banks in Asia also allow greater exchange-rate flexibility, as they are likely to do and as Malaysia has already done.

Although there are parallels with the 1971 exit from Bretton Woods, there are also important differences. This time, the United States did not need to use tariff increases to get results, as with the 10 percent "additional tax" on imports in 1971. And unlike the 1971 "turmoil" in financial markets—as Robert Solomon wrote in his financial history—this exit is characterized by low volatility and a great degree of stability in the world's markets. These differences are in part due to a highly effective diplomatic strategy developed in the summer of 2003 under the leadership of President Bush and Treasury Secretary John Snow and implemented persistently for the past two years.

The more flexible exchange rates that China has just instituted are good for China as well as America and the rest of the world.

What was the strategy? First, making the case that a more flexible exchange rate is good for China as well as America and the rest of the world. Second, working with the Chinese on specific prior actions needed for a flexible exchange rate, including the development of spot and futures markets. Third, working with the other G7 countries—France, Germany, Japan, Italy, Canada, and Britain—to make the case multilaterally rather than bilaterally; for example, last year all the G7 countries issued a common statement calling for this exchange-rate flexibility, and the Chinese central bank governor and finance minister then met jointly with Secretary Snow, Alan Greenspan, and their counterparts in the G7 to discuss the details. The Chinese monetary officials made it very clear that their goal was price stability and that they were taking specific steps to achieve the flexibility needed to achieve this goal. Fourth, explaining this strategy to Congress, industry groups, and financial-market participants so as to reduce the risks of currency volatility and prevent isolationist legislation.

By the start of this year, it was clear to U.S. officials that the necessary prior steps had been taken. After a few months of purposefully quiet time in the diplomatic efforts, Secretary Snow and other administration officials began to say this explicitly and publicly, and soon thereafter the Chinese abandoned their peg. The Chinese are now introducing flexibility gradually. A small 2 percent depreciation followed by a 0.3 percent limit on daily currency changes is just the first step.

What are the best ways to ensure that both policy progress and financial stability continue? By applying the lessons learned from the recent diplomatic success: the inclusion of China in the G7 meetings (now more important than ever for financial stability); close consultation between the administration, Congress, and the private sector to avoid isolationist legislation and encourage rational policy decisions—rather than hysterical China-bashing—on important foreign investment issues such as the recently withdrawn CNOOC bid for Unocal; dissemination of information about how the new policy regime in China and other parts of Asia is progressing; and a wider understanding of how the financial diplomacy strategy was developed, implemented, and worked.

This essay appeared in the *Wall Street Journal* on August 15, 2005.