other countries, especially emerging markets that are floaters.

Collective action problems arise from these asymmetric exchange rate arrangements. Many emerging market countries in East Asia, even those that ostensibly float, explicitly or implicitly monitor their real exchange rates. They are reluctant to see their currencies appreciate excessively, especially relative to other countries in the region. This reluctance hinders nominal exchange-rate adjustment between East Asia and the advanced economies at a time when asymmetries between the two groups urgently call for real exchange-rate adjustment.

Concerns about exchange rate appreciation and overshooting are not limited to the emerging markets, of course. The recent intervention in foreign exchange markets by committed floaters such as Japan and Switzerland highlights the tensions building up in the global economy as public debt levels in the major reserve currency areas—the US and Europe—impose more of a burden on the Federal Reserve and the European Central Bank to maintain lax monetary policy with attendant spillovers to the rest of the world (as discussed in more detail in the next chapter).

Fixing also creates policy dilemmas for countries seeking to fix. These countries are by choice dependent on their partners' monetary policy decisions, especially but not only when they have opened the financial account. Attempting not to import foreign monetary conditions while fixing has required extraordinary measures.

Take China, whose capital account is only partially open. Experiencing large balance of payments surpluses, the People's Bank of China (PBOC) has regularly intervened in the foreign exchange market to limit the appreciation of the renminbi. The resulting increase in China's foreign exchange reserves accounts for almost all the increase in China's monetary base. To sterilize the increase in the money supply created by its intervention in the foreign exchange market, the PBOC has been forced to sell all of its holdings of government securities and to sell central bank bills to state-owned commercial banks. This strategy has been abetted by repressed interest rates, creating distortions in financial markets and in effect taxing households who receive negative real returns on their massive stock of bank deposits.

The financial crisis heightened these tensions. Its size and depth increased the incentive for emerging markets experiencing sharp capital flow reversals to self-insure by accumulating even larger reserves.[18] Moreover, the instability of world demand has caused a number of countries, not all of them in Asia, to place an even greater premium on managing the level of the real exchange rate. This has led them to deploy a broad array of tools, including capital controls, to prevent unwanted appreciation (for a more detailed discussion of this issue, see Chapter 4 below).

There are two possible assessments of these trends. One minimizes the importance of the asymmetry of exchange rate policies on the grounds that what matters for international adjustment is real exchange rates, which governments cannot control in the long run. Thus, recent price and wage inflation in China is causing non-trivial appreciation of the renminbi in real terms vis-à-vis the dollar even while the nominal bilateral exchange rate remains relatively stable.

The alternative view, which we share, is that international adjustment via wage and price inflation is slow and inefficient. The world economy would be better served by a speedier mechanism involving greater exchange rate flexibility. If flexibility is not feasible for domestic political reasons, then incentives need to be put in place to make sure large nations among both groups—fixers but also floaters—internalize the international effects of their actions.

[18] That factor alone suggests that fixed or semi-fixed exchange rate arrangements will be around for some time in emerging markets.