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AFTER THE FALL: EAST ASIAN EXCHANGE RATES SINCE THE CRISIS

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ABSTRACT

Exchange rates were at the center of the East Asian financial crisis. A decade later, what has been learned? This essay focuses on exchange-rate regimes and alignments in the region. The aim of the essay is both retrospective and prospective – to review what has happened to date and to evaluate prospects for the future. Analysis addresses a trio of critical questions: (1) What role did exchange rates play in East Asia's crisis? (2) What explains currency strategies in the period since 1997-98? (3) What is the outlook for the region's exchange-rate regimes in the future? Evidence suggests that the role of exchange rate-regimes in the crisis was more indirect than direct; pre-crisis currency strategies contributed to events mainly by encouraging risky modes of market behavior that added to the fragility of national economies. In turn, this helps to explain the high degree of continuity of practice in most regional economies since 1997-98. Reforms have been instituted – but mainly in related policy areas rather than in exchange-rate regimes themselves. The reason is plain. Exchange-rate regimes are seen as instrumental, not as an end in themselves, and therefore have been adjusted only where change seemed appropriate to serve broader developmental goals. Despite the risks involved, governments have resisted and are likely to continue to resist more radical innovations in their currency strategies.

The East Asian crisis began with a classic currency collapse: the Fall of the Baht. Soon nearly every economy in the region came under pressure from investor panic and capital flight – a contagion of “bahtulism,” as a few observers grimly quipped. While some governments successfully held firm, others were helpless to prevent massive depreciations. For many, exchange-rate instability was a direct cause of the economic turbulence that followed. The experience was searing for all concerned.

A decade after the Fall of the Baht, what has been learned? This essay focuses on exchange-rate regimes and alignments in East Asia. For the purposes of the essay, the East Asian region is defined to include the ten members of the Association of Southeast Asian Nations (ASEAN) plus China, Hong Kong, Japan, South Korea (hereafter Korea), and Taiwan. Governments in the region have made a number of adjustments in their exchange-rate regimes designed *inter alia* to protect their economies from a repetition of the events of 1997-98. The aim of this essay is both retrospective and prospective – to review what has happened to date and to evaluate prospects for the future. What has (or has not) changed, what is driving currency strategies in the region, and what more, if anything, might governments do to prepare themselves for possible challenges in years to come?

The first two sections of the essay set the stage for analysis. The first section resumes the core factors involved in a state’s choice of exchange-rate regime (ERR), including political as well as economic considerations. All governments face a number of critical tradeoffs in framing their currency strategies; there is no obvious “first-best” policy for any economy. The second section summarizes the recent history of exchange-rate policy in East Asia, focusing on actual behavior as well as official pronouncements. A glance at the record highlights both a

considerable diversity of arrangements across the region as a whole and a remarkable continuity of practice in most individual countries.

Subsequent sections address a trio of critical questions: (1) What role did exchange rates play in East Asia's crisis? (2) What explains currency strategies in the period since 1997-98? (3) What is the outlook for the region's ERRs in the future? Evidence suggests that the role of ERRs in the crisis was more indirect than direct; pre-crisis currency strategies contributed to events mainly by encouraging risky modes of market behavior that added to the fragility of national economies. In turn, this helps to explain the high degree of continuity of practice in most regional economies since 1997-98. Reforms have been instituted – but mainly in related policy areas rather than in ERRs themselves. The reason is plain. ERRs are seen as instrumental, not as an end in themselves, and therefore have been adjusted only where change seemed appropriate to serve broader developmental goals. Despite the risks involved, governments have resisted and are likely to continue to resist more radical innovations in their currency strategies.

CHOOSING AN EXCHANGE-RATE REGIME

In analytical terms, the choice of an ERR may be framed in a variety of ways. In earlier years, the issue was cast in simple binary terms: fixed versus flexible exchange rates. A state could adopt some form of peg for its currency or it could float. Pegs might be anchored to a single currency or to a “basket”(a weighted average of anchor currencies); they might be formally irrevocable or based on a more contingent rule; they might crawl or take the form of a

target zone. Floating rates, conversely, might be managed (a “dirty” float) or else just left to the interplay of market forces (a “clean” float).

More recently, as international capital mobility has grown, the issue has been recast – from fixed versus flexible exchange rates to a choice between, on the one hand, contingent rules of any kind (“soft pegs”) and, on the other hand, the so-called corner solutions of either floating or some form of monetary union (“hard pegs”). Today, according to a now fashionable argument known as the bipolar view, no intermediate ERR can be regarded as tenable. Owing to the development of huge masses of mobile wealth capable of switching between currencies at a moment’s notice, governments can no longer hope to defend policy rules designed to hit explicit exchange-rate targets. The middle ground of contingent rules has in effect been “hollowed out,” as Barry Eichengreen (1994) memorably put it. ERRs, it is predicted, will increasingly be driven to one corner solution or the other.

But is that realistic? The bipolar view implicitly assumes that when it comes to choosing an ERR, governments have just one objective – to avoid speculative crises. In effect, no tradeoff is considered possible between currency stability and other policy goals. But that hardly seems plausible. In reality, tradeoffs are made all the time when currency strategy is decided. No option is ruled out *a priori*, including contingent rules. As Jeffrey Frankel has written: “Neither [corner solution] sweeps away all the problems that come with modern globalized financial markets.... Optimization often... involves an ‘interior’ solution” (Frankel 1999, 2).

Optimization of course implies politics. The core issue is the policy dilemma posed by the familiar Unholy Trinity (Cohen 1993) – the mutual incompatibility of exchange-rate stability, capital mobility, and autonomy of national monetary policy. Derived from the well known

Mundell-Fleming model of open-economy macroeconomics, the Unholy Trinity suggests that in an imperfect world, there simply is no perfect solution. Hard pegs, for example, might seem desirable because they reduce uncertainty and lower transactions costs. Their efficiency benefits could be considerable. But with capital free to move, a fixed rate also deprives a government of control over domestic monetary conditions, compromising management of the national economy. Sensitivity to external shocks is heightened, making the country hostage to policies made elsewhere. Floating, conversely, preserves more of a government's capacity to manage macroeconomic performance, but at a risk of provoking destabilizing speculation. Moreover, uncertainty is increased, raising transactions costs. The attraction of the middle ground of contingent rules is that they might, in some form, capture the advantages of each corner solution while avoiding their disadvantages.

In all this, governments are essentially on their own. Given the multiple considerations involved, which are as much political as economic, it is obvious that there can be no magic bullet – no single “first-best” policy that would be suitable for all. Quite the reverse, in fact. Ever since the breakdown of the Bretton Woods par-value system in the early 1970s, it has been understood that when it comes to ERR choice, one size definitely does not fit all. Under the amended rules of the International Monetary Fund (IMF), states are now free to make their own choices, depending on the importance each government happens to attach to the benefits and costs of alternative options. States that value certainty more than policy autonomy will be attracted toward some form of pegging; conversely, those that prefer a degree of macroeconomic flexibility, even at the risk of an occasional currency crisis, will move toward some manner of floating.

Few generalizations, however, seem possible. While there have been many empirical studies of the determinants of ERR choice in recent years, by both economists and political scientists, results have been inconclusive at best and often inconsistent (Rogoff *et al* 2004, 17-20). In the end, the tradeoffs that states make tend to be designed to accommodate their own unique needs and circumstances.

RECENT HISTORY

How have policy strategies in East Asia changed since the crisis? A review of available evidence suggests two central observations.

First, reflecting the variety of tradeoffs that each state must make, is the considerable *diversity* of currency policies across the region. ERRs today, a decade after the crisis, run the gamut from independent floating to the hardest of hard pegs. Whatever adjustments governments have made in the last decade, they have not resulted in a closer alignment of exchange-rate arrangements.

Second, looking at individual economies, is the relative *continuity* of currency policies in the region. The crisis was massively disruptive, sending a number of the region's exchange rates into a tailspin. Depreciations ranged in magnitude from some 10-20 percent in Taiwan and Singapore to as much as (at one time) 80 percent in Indonesia. Pressures for reform were enormous. Yet in response, few East Asian ERRs have undergone radical change, and even fewer have moved in line with the prediction of the bipolar view. Overall, it would appear that

after a period of upheaval, practice in most cases has returned to something quite like what prevailed before the crisis erupted.

Diversity

Empirically, ERRs can be identified in one of two ways – from official statements or from observations of actual behavior. Either way, the evidence shows a wide diversity of arrangements in East Asia.

Formal exchange-rate policies are defined by the pronouncements of central banks or their equivalent. A summary of official policies for the period 1996-2005, as reported by the IMF, is provided in the first column of Table 1.

Formal policy, however, only tells part of the story. Actual behavior, as we know, can diverge significantly from *de jure* ERRs. For instance, countries that claim officially to maintain a flexible exchange rate may in fact intervene heavily to prevent their nominal rates from moving – a pattern that Calvo and Reinhart (2000) have dubbed “fear of floating.” Conversely, others that ostensibly maintain a formal peg may in practice change their parities so often that they more closely approximate a floating regime. Governments do not always act in a manner consistent with their declared ERRs.

To complete the story, therefore, it is necessary also to look at what governments do, not just at what they say. Toward that end, a number of new classification systems have emerged – measures of *de facto* ERRS – that rely on actual behavior rather than official statements. Among these, the most useful for this essay’s purposes are the estimates of Eduardo Levy-Yeyati and

Federico Sturzenegger (2005). The Levy-Yeyati-Sturzenegger classification scheme (hereafter LYS) extends further than any other study presently available, through 2004. It also includes the largest number of the region's economies, thirteen out of fifteen (all but Taiwan and Viet Nam).

LYS use a cluster analysis technique to group economies according to the joint behavior of international reserves (a measure of intervention activity) and nominal exchange rates. ERRs are categorized into four distinct types. In order of increasing degree of flexibility, these are:

- (1) Fixed regimes (high volatility of reserves, signifying extensive intervention, combined with low volatility of the exchange rate).
- (2) Dirty crawling pegs (stable incremental changes of the exchange rate combined with active intervention).
- (3) Floating regimes (low volatility of reserves combined with high volatility of the exchange rate).
- (4) Dirty float (high volatility of both reserves and the exchange rate).

The first two of these types may be regarded as closely related versions of soft pegs. The latter two types may be regarded as alternative versions of floating. A comparison of *de facto* ERRs with *de jure* arrangements, based on LYS, is provided in the second column of Table 1.

A look at the table confirms the diversity of currency arrangements in the region. At one extreme, two economies, Brunei and Hong Kong, maintain currency boards – a particularly hard form of pegging. With a currency board, the local money is firmly tied to a designated anchor currency. The exchange rate between the two currencies is rigidly fixed, ostensibly irrevocably. Most importantly, any increase in the issue of local money must be fully backed by an equivalent increase of reserve holdings of the anchor currency, making the local currency little more than

foreign money by another name. Brunei's currency board, which has existed since 1967, is based on the Singapore dollar. Hong Kong's currency board, dating from 1983, anchors on the U.S. dollar. For neither Brunei nor Hong Kong, evidently, is monetary autonomy a matter of high priority. Being small and very open economies, both place more emphasis on maximizing efficiency benefits and minimizing the risk of adverse speculation.

At the opposite extreme are Japan and Taiwan, which for the most part allow their currencies to float freely. Taiwan's interventions are limited mainly to "leaning against the wind"; Japan, after a period of massive intervention in 2003-2004, has largely refrained from active management of the yen. For both countries, control over domestic monetary conditions is obviously the most important consideration. Korea and the Philippines also claim to maintain independent (clean) floats but in fact actively manage their exchange rates. LYS classify Korea's *de facto* regime as fixed (meaning relatively low exchange-rate volatility) and that of the Philippines as a dirty crawling peg (meaning stable incremental changes of the exchange rate) – both examples, apparently, of some "fear of floating."

Eight countries in the region (Cambodia, Indonesia, Laos, Malaysia, Myanmar, Singapore, Thailand, and Viet Nam) are classified by the IMF as having managed floats "with no pre-announced path for the exchange rate." In practice, however, several of them – most notably, Cambodia, Myanmar, and Singapore – also appear to exhibit a considerable "fear of floating." Until 2002 the same was true as well of Indonesia, though in the most recent period behavior seems to have moved more closely in line with Jakarta's declared policy of a managed float.

Only one country in the region today operates a conventional soft peg – giant stability-minded China. Previously anchored on the U.S. dollar, the peg for China's yuan was formally switched in 2005 to a basket of currencies. Until 2005, Malaysia also maintained a peg anchored to America's greenback, before changing to a managed float.

Continuity

The diversity of ERRs across the region is matched by their continuity in individual economies. The popular impression is that currency strategies underwent a revolution after the ravages of the crisis – a perception that, in some cases, governments have deliberately fostered. In practice, however, as Table 1 demonstrates, radical change has been relatively rare and has not always been in the direction predicted by the bipolar view. Some modifications have been introduced. But contrary to the bipolar view, there has been no broad trend toward one corner solution or the other.

Of the fifteen economies in the region, ten have the same official ERR now that they had prior to the crisis. These include the two currency boards (Brunei and Hong Kong), three of the independent floaters (Japan, Philippines, Taiwan), and five with managed floats (Cambodia, Indonesia, Malaysia, Singapore, and Viet Nam). For these ten, formally, there has been no change at all.

Moreover, of the remaining five, two have moved in a direction contrary to the prediction of the bipolar view. The one formal pegger in the region, China, officially maintained a managed float before the crisis, while Laos has shifted from an independent float to managed

flexibility. Both are now further from the corner solution of a pure float than they were a decade ago. Only Korea, Myanmar, and Thailand have formally moved closer to a corner solution. Both Myanmar and Thailand officially abandoned pegging for a managed float – Myanmar in 2002, Thailand in 1998. Korea shifted from managed flexibility to an independent float in 1998. Malaysia’s switch to a managed float in 2005 was simply a return to the ERR that it had maintained before the crisis erupted.

Continuity is also evident in the LYS data. Of the thirteen countries included, six show no change of actual practice (Brunei, China, Hong Kong, Japan, Korea, and Myanmar) while three others shifted just from one type of soft peg to another (Malaysia, Philippines, and Singapore). Only four made a more radical switch. Cambodia moved from a float to a dirty crawling peg, while Indonesia, Laos, and Thailand moved in the reverse direction, from dirty crawling pegs to floating. None of this adds up to the widespread “hollowing out” that many have expected.

Quite the opposite, in fact. Whether judging from formal pronouncements or the LYS data, it is evident that most governments in the region prefer to take an active role in managing their currencies and, where possible, to aim for some kind of target, adjusting domestic policy if necessary to limit exchange-rate volatility. As one study concludes, “all the concerned countries display some traits of involvement in exchange rate management” (Tiwari 2003, 24). Of the three countries that officially claim to have adopted a policy of floating since the crisis, two (Korea and Myanmar) in practice still seek to keep movements of their exchange rates as limited as possible – a kind of soft peg. Some version of soft pegging can also be found in Cambodia, Malaysia, Philippines, and Singapore; and of course China still retains its formal peg. Interior

solutions based on implicit or explicit contingent rules were common prior to the crisis a decade ago. Apparently they remain as popular as ever. The overall picture is largely one of continuity rather than discontinuity.

THE CRISIS

What role did exchange rates play in the events of 1997-98? The crisis was the worst to hit East Asia in generations. Were the region's ERRs to blame?

There can be no doubt that exchange rates were a central part of the story. Soft pegging was the policy of choice in all the countries worst hit by the Fall of the Baht. Whether *de jure* or *de facto*, currency targets offer a tempting prey for speculators. Once turbulence hit the region, the markets were bound to test the credibility of exchange-rate commitments. The rapid spread of bahtulism should have been no surprise.

But that does not mean that exchange rates were the central cause of the crisis. As innumerable sources have noted, the roots of the episode actually go far deeper, drawing nourishment from a variety of sources. In the words of T.J. Pempel, "a complicated multilevel dynamic... was at play" (Pempel 1999, 4), involving forces both foreign and domestic, political as well as economic. Of particular importance were critical defects in the development model favored by most East Asian governments – an export-led model that rested, *inter alia*, on a foundation of political patronage and close personal connections among powerful politicians, bankers, regulators, and business interests. While "crony capitalism" seemed to work well in good times to promote rapid economic growth, it also proved a barrier to swift and effective

policy reform once clouds began to gather. Also of importance was the spread of economic interdependence across East Asia, a growing web of commercial and investment ties, which made individual economies highly vulnerable to contagion once the storm struck. Nor can we neglect the role of financial liberalization, which opened local capital markets to foreign creditors and investors. The decade prior to the crisis saw a widespread loosening of exchange controls, leading to a marked increase in the degree of capital mobility in the region. The more governments relaxed their vigilance over financial flows, the tighter they drew the noose of the Unholy Trinity around their own necks.

In this complex environment, exchange rates are best thought of as having played the role of catalyst – an indirect rather than direct cause of the crisis. Soft pegs *per se* were not the culprit. Rather, the problem lay in risky modes of behavior that were encouraged by government stabilization of exchange rates. Pegs appeared to reduce uncertainty for trade and investment decisions, providing an implicit guarantee against exchange risk. But in suppressing volatility, governments also ruled out the disciplinary power of potential rate adjustments. Ultimately, currency stability was to prove illusory. But so long as market actors held faith in the illusion, they felt free to engage in practices that, cumulatively, simply added to the fragility of national economies.

Historically, the region's economies, like most developing countries, suffered from what has been called "original sin" (Eichengreen and Hausmann 1999) – an inability to borrow internationally in their own currencies. With currency rates seemingly stabilized, however, banks and firms felt free to borrow liberally abroad. Massive currency mismatches built up between liabilities denominated in foreign exchange and claims denominated in local money.

Yet few saw fit to hedge their debts against the risk of future depreciation. Why buy relatively expensive currency futures or forwards when the outlook was for exchange-rate stability?

Likewise, much borrowing was done at short-term to finance longer-term investment, building up substantial maturity mismatches as well.

The irony is obvious. The longer governments managed to sustain the illusion of currency stability, the more they fed what Keynes called the self-destructive “animal spirits” of entrepreneurs and financiers. As Eichengreen has commented: “Ironically, Asian governments’ very success at pegging their exchange rates was one factor behind the severity of the crisis, for it lulled domestic banks and corporations into a false sense of security” (Eichengreen 1999, 163). The easy availability of foreign capital led to exuberant credit expansion, dangerous asset bubbles in real estate and equities, and over-investment in productive capacity – all factors that contributed to the severity of the crisis once the Thai baht fell. In effect, the region’s ERRs were like an indulgent parent who, by sparing the rod, spoiled the child.

Moreover, the problem was compounded by the choice of anchor for the region’s pegs. For all, this was the U.S. dollar. Many of the soft peggers claimed to be linking to a basket of currencies – an “effective” exchange rate, calculated as a weighted average of several anchor currencies – rather than to any single anchor alone. In practice, however, heaviest weight by far tended to be placed on America’s greenback. Even ostensible free floaters like Japan or Taiwan paid close attention to their dollar exchange rates, using the greenback for intervention purposes. In most cases, currency stability simply meant mooring to the dollar and shadowing it as closely as possible. Currencies tended to be much more volatile in effective terms than they were in relation to the dollar alone (Williamson 1999).

There were two reasons for the choice of the dollar as an anchor. First was the sheer convenience of making use of the world's predominant international currency, already widely employed around the globe for reserve and intervention purposes. Second was the central importance of the United States as the biggest market for most of the region's exporters. A stable link to the greenback not only facilitated sales to America's consumers. In parallel, dollar pegs also served indirectly to harmonize nominal currency values, thus removing exchange-rate variation within the region as a possible threat to relative competitive positions.

Unfortunately, a common alignment of nominal currency values could not prevent the emergence of "real" exchange-rate misalignments, arising from differential inflation rates or other causes. Underlying changes in relative competitive positions across the region were masked so long as the dollar remained comparatively weak, as was the case in the early 1990s. A cheaper greenback meant greater competitiveness for East Asian exports in third markets, supplementing sales in the United States. But once the dollar began to strengthen in the mid-1990s, growth of export revenues quickly decelerated, worsening trade balances and bringing misalignments to the surface. The impact was particularly sharp in countries like Indonesia, Malaysia, and Korea. Worst hit was Thailand, whose current-account deficit by the start of 1997 had swollen to nearly 8 percent of gross domestic product (GDP), well beyond what might be considered prudent. The Fall of the Baht was just a matter of time.

In retrospect, it is clear that a different approach to exchange-rate policy might well have averted the worst of these fragilities. Soft pegs first encouraged risky market practice while masking accumulating stresses, then when circumstances deteriorated proved an easy target for speculation. Hence it is no surprise that for many observers the policy lesson at the time seemed

clear. Soft pegs were out. Corner solutions were in – either hard pegs or floating. The sudden emergence and popularity of the bipolar view can be attributed directly to East Asia’s experience a decade ago. If the region’s crisis seemed to demonstrate anything, it was the futility of interior solutions based on implicit or explicit contingent rules.

INERTIA

How, then do we explain the overall picture of continuity in the decade since the crisis? Contrary to the bipolar view, there has been no rush to the corners in East Asia. Hard pegs have attracted no new adherents; most governments, even those with ostensibly flexible ERRs, continue to demonstrate a marked “fear of floating.” Moreover, in almost all cases America’s greenback remains the dominant influence on exchange rates. According to one representative study, the dollar’s predominant weight in East Asian currency baskets, following a brief post-crisis hiatus, has largely returned to its pre-crisis levels, ranging from about 65 percent for Singapore to above ninety percent in Cambodia, Laos, Malaysia, Myanmar, the Philippines, and Viet Nam (Volz 2006). Only in Indonesia, Korea, and Thailand has there been a noticeable increase of flexibility vis-à-vis the dollar – and even there the change has been modest at best (World Bank 2006: 9). Even China, despite its switch to a formal basket peg, continues to shadow the greenback closely.

Is there a method to all this inertia, or madness?

Madness?

Many observers would say madness. Soft pegs, critics argue, are an open invitation to speculators. If the Unholy Trinity teaches anything, it is that in an environment of financial openness, market actors sooner or later can be counted upon to test exchange-rate commitments, as they did in 1997-98. Unless governments are willing to follow the example of Brunei or Hong Kong, abandoning altogether any ambition for a monetary policy of their own, they cannot hope to sustain currency targets indefinitely.

So far, so uncontroversial. The criticism is well understood and helps to explain why even the most determined *de facto* peggers in East Asia, such as Korea, the Philippines, and Singapore, decline to establish a target *de jure*. Once a currency gets in trouble, a formal peg offers a one-way option to speculators. Much may be gained by betting on a forced devaluation, while little will be lost if the currency is successfully defended. So why tempt speculators unduly? By saying one thing while doing another, governments can hope to increase uncertainty and thus dilute the one-way option. The sole exception in the region, China, feels confident in its ability to maintain a *de jure* peg only because of the broad panoply of exchange controls that Beijing has long employed to limit the degree of capital mobility across its borders.

But dissembling is not without its own risks. Despite efforts to strengthen local capital markets – including, most notably the Asian Bond Fund and Asian Bond Markets Initiative (Amyx 2006) -- most external borrowing in the region continues to be denominated in foreign currency. East Asia still suffers substantially from “original sin.” Soft pegs, therefore, even if no longer *de jure*, could once again invite a dangerous build-up of unhedged currency mismatches. The risk is less serious at the level of government borrowing; across most of the region, public foreign currency debt has actually fallen sharply in relation to exports and

reserves. But as the Bank for International Settlements tactfully puts it, mismatches at the private level “remain significant,” suggesting a “need to ensure that the financial sector is taking adequate care to manage the risks associated with these mismatches” (Bank for International Settlements 2005, 53).

Worse, dissembling could do serious damage to government reputations, compromising efforts to rebuild confidence in public authority since the crisis. As Eichengreen has suggested, “pretending to float while really attempting to limit the currency’s fluctuation... is not a way of building policy credibility” (Eichengreen 2004, 62). Quite the contrary, in fact. By openly encouraging disbelief in their own official statements, governments risk cultivating a broader cynicism about their policy intentions in general.

Moreover, critics contend, persistence in targeting most closely on the dollar compounds the problem, by holding the region’s trade competitiveness hostage to the fortunes of America’s currency. Here too would seem to be madness. Anchoring, however informally, to the dollar makes an economy vulnerable to fluctuations between the greenback and other major currencies – what was once known as the “outer exchange-rate problem” (Cohen 1977, 183-184). In the most recent years, as in the early 1990s, the outer exchange-rate problem has actually worked to the region’s advantage. With the greenback once more weakening under the pressure of America’s accelerating payments deficits, East Asian economies have “ridden the dollar down,” regaining a competitive edge in European markets and elsewhere. But the process could also go the other way, as it did in the mid-1990s, again worsening trade balances. Does it really make sense to tie the region’s fate so tightly to the vagaries of currency movements beyond its control?

Method

Such criticisms, however, are myopic, if not outright blinkered. East Asian currency strategies can hardly be described as mad; there is indeed method in their inertia. Regional governments rationally treat their choice of ERR as a deeply political matter, with far more at stake than just the threat of speculation or the outer exchange-rate problem. Currency policy is embedded in an optimization process that encompasses a much broader range of issues, including many that are considered vital to a government's survival or conception of national interest.

Perhaps most vital is a sustained rate of economic development, to absorb surplus labor and lift living standards. For most states in the region, be they democratic or authoritarian, an implicit social contract links the legitimacy of governments directly to their success in promoting rapid growth. Economic progress may not guarantee longevity of office. But its absence will almost certainly make the life of political incumbents more hazardous. Poor economic prospects translate directly into dim career prospects for those in positions of authority.

In turn, growth demands a continued expansion of exports, since East Asian governments still rely most heavily on the region's traditional export-led development model. Trade expansion is valued not only in broad economic terms, for the jobs it creates and the tax revenues it generates. It is also prized in domestic political terms, for the material benefits it brings to specific, influential constituencies. Although a number of states have moderated some of the more egregious manifestations of crony capitalism since the crisis (MacIntyre 2006), there can

be no doubt that trade interests remain disproportionately powerful in the give and take of domestic politics. Governments have every reason to keep such groups happy.

Finally, trade expansion is valued in national-security terms, for its contribution to freeing resources that may be used for military purposes – what Joanne Gowa (1994) has called trade’s “security externalities.” China is perhaps the most prominent example in the region of a government that has exploited its remarkable trade gains to help modernize its armed forces and enhance its ability to project power beyond its borders. But the Chinese are hardly alone. The neighborhood is one of the most hotly contested areas in geopolitics today. East Asians know that they must do what they can to ensure their own defense.

In this context, the ERR is seen as instrumental rather than as an end in itself --just one more policy tool in service to the objectives of development and trade expansion. And to preserve the usefulness of that tool, most East Asian governments prefer to retain as many degrees of freedom as possible, avoiding corner solutions that might inhibit their autonomy. “Fear of floating” actually makes sense if an unmanaged exchange rate could result in undue volatility, depressing exports. Conversely, avoidance of a hard peg makes sense so long as governments remain committed to active management of the development process. The continuity of currency strategies in the region, therefore, is no accident. It is in fact part and parcel of the pragmatism that characterizes all dimensions of policy in that part of the world. Soft pegs leave the widest possible latitude to respond to changing circumstances. The result is a compromise, but hardly an unreasonable one.

Nor does the persistence of a dollar anchor seem unreasonable, given the still central importance of the U.S. market for regional exporters. With 30 percent of world GDP, America

remains the “consumer of last resort” for East Asia’s ever growing output. It hardly seems irrational, therefore, to seek to preserve a stable relationship with the greenback, in order to sustain sales. In fact, governments have intervened heavily to keep their exchange rates from appreciating significantly in dollar terms, accumulating record amounts of reserves in the process – more than \$800 billion in China and Japan, more than \$200 billion in Korea and Taiwan. Continued targeting on the dollar is no accident, either.

Does this mean that nothing has been learned from the crisis? Not at all. The risks of inertia, as noted, are widely understood. That is why, China apart, most states in the region now eschew *de jure* targets that might invite destabilizing speculation. Moreover, even while continuing to attach heaviest weight to the greenback, some now appear willing to relax the dollar relationship to a considerable extent when conditions warrant (Eichengreen 2004; Fukuda and Ohno 2005). In some cases, such as Japan and Korea, exchange rates have been allowed to appreciate moderately in order to avoid even larger dollar accumulations. In short, much has in fact been learned. It is just that results of the learning process show up mainly in related policy areas rather than in the ERR itself. Recognizing that exchange rates were at best a catalyst, not a direct cause of the crisis, most effort has gone into reducing the many other fragilities that turned the Fall of the Baht into such a disaster.

Internally, reforms have been undertaken to reduce the vulnerability of financial markets (Hamilton-Hart 2006). Externally, the region’s enormous new reserve stockpiles, held mainly in the form of U.S. Treasury obligations, provide a more comfortable cushion should another crisis hit. Mainly the by-product of interventions designed to preserve export competitiveness, these reserves are costly in opportunity-cost terms. The interest rate earned on U.S. Government debt

tends to be far lower than what might be earned on more productive investments. But the reserves do also offer the benefit of a kind of insurance policy – a hedge against the risk of future capital outflows. And that hedge, in turn, has been further bolstered by new efforts to cultivate financial collaboration at the regional level, including most notably the Chiang Mai Initiative, intended to provide mutual financial support when needed to combat adverse speculation (Henning 2002; Amyx 2006).

In short, there is indeed method in the region's inertia. If currency strategies have been adjusted only marginally, it is in order to best preserve their instrumental role in support of broader developmental goals.

THE FUTURE?

What of the future? Inertia in ERR choice may make sense – but does it make the *most* sense? Or are there other strategies that might achieve a more favorable tradeoff among policy objectives?

Much depends, of course, on the nature of the threat. Of most salience today is East Asia's continued allegiance to dollar pegging, which for the region as a whole has produced massive trade surpluses matched by America's corresponding deficits – a pattern that has been described as a “revived” Bretton Woods system or Bretton Woods II (Dooley *et al.* 2004). Much doubt exists about whether the Bretton Woods II pattern is sustainable (Eichengreen 2007). The question on everyone's mind is: What happens if America's deficits trigger a new dollar crisis? Will regional governments be content to go on building up their huge stockpiles of greenbacks,

despite low interest rates and significant dollar depreciation? Could new real misalignments be revealed? And what happens if someone then breaks ranks, precipitating a realignment of nominal rates? Turbulence could once again hit the region, as it did in 1997-98.

Asians are acutely sensitive to the dilemma they face. To forestall a repetition of history, myriad alternative strategies have been actively discussed. Broadly, six possible regimes dominate conversation: free floating, currency unification, a dollar standard, basket pegging, a so-called Asian Currency Unit (ACU), or direct monetary-policy coordination. All have their advantages. But each has disadvantages as well – not least, in most cases, a distinct lack of political appeal. Except possibly for some modest version of either of the last two, none is apt to be adopted any time soon despite the obvious risks of the status quo.

Free floating

At one extreme are proposals to free exchange rates altogether – the corner solution of an independent float. The case for floating is clear (Goldstein 2002; Eichengreen 2004). With one stroke, the Gordian knot of the Unholy Trinity is cut, releasing economies from the constraints imposed by any kind of exchange-rate rule. If something has to give, advocates argue, it should be the exchange rate, not capital mobility or policy autonomy. Capital mobility is essential to support productive investment; policy autonomy is critical if governments are to sustain the growth process that is so vital to their legitimacy. Exchange-rate stability simply represents a lower order of priority.

Most importantly, floating could help forestall a build-up of real misalignments, thus easing adjustment should the Bretton Woods II pattern prove unsustainable. Regional governments, however, appear little convinced. Of much greater concern to them is the risk that unpredictable exchange-rate movements could exacerbate rather than inhibit misalignments, disrupting exports and, by implication, growth. They, as well as anyone, know how much nominal currency values can shift even when underlying economic circumstances are relatively stable. Foreign-exchange markets, like all asset markets, are driven by interdependent expectations, which means that multiple equilibria are possible. A glance at the history of major currencies like the dollar, which have been floating since the early 1970s, shows that medium-term swings of 20-40 percent or more are by no means uncommon. For the currencies of East Asia, where markets are still much thinner than in the more advanced economies, oscillations could be even more pronounced.

In their pragmatic pursuit of sustained development, few governments in the region have shown an appetite for that much uncertainty. Quite the opposite, in fact. “Fear of floating” is deeply institutionalized in East Asia. Even Japan, whose yen has been formally floating for decades, intervenes frequently to exercise some degree of control over its exchange rate. A switch to unrestrained flexibility, leaving the determination of currency values more or less to market forces, would be out of character for most states in East Asia. It is not likely that the tigers will change their stripes any time soon.

Currency unification

What about the other corner solution – currency unification? The case for a common currency is equally clear. If “fear of floating” is the problem, an East Asian monetary union would seem an obvious solution, since it would, *ex hypothesi*, eliminate all risk of exchange-rate instability in the region. The idea is widely touted (Mundell 2004) and has even been endorsed as a “distinct possibility” by the heads of government of ASEAN (Association of Southeast Asian Nations 1999).

Reasoning is by analogy with Europe’s Economic and Monetary Union (EMU). At the microeconomic level, a common currency like the euro would reduce transactions costs, thus encouraging intra-regional trade. At the macroeconomic level, it would offer insulation against speculative crises by reducing the risk of incompatible exchange-rate movements or other negative spillovers of the sort observed after the Fall of the Baht. A joint money would be easier to manage in the event of a new dollar crisis, as compared with a diverse collection of national currencies of differing degrees of credibility.

But is the option realistic? Here too there are problems. Individually, as Natasha Hamilton-Hart (2003) has emphasized, government capacity in many cases may simply be inadequate to carry through such a complex and demanding project. Collectively, there is the challenge of identifying just which economies in the region might become involved. East Asia offers no natural “club” comparable to the membership of the European Union and is riven with political tensions.

In short, the requisite conditions for a successful monetary union are just not there. This was true before the crisis (Cohen 1993), and it remains true today. Ten years ago, just as the crisis was starting, Joseph Yam, head of the Hong Kong Monetary Authority, threw cold water

on the idea in delivering the prestigious Per Jacobsson Lecture at the annual meeting of the International Monetary Fund. Regional monetary integration, he declared, “is inappropriate, at least for the time being” (Yam 2007, 21). A decade later, in another Per Jacobsson Lecture by Singapore’s Second Minister for Finance Tharman Shanmugaratnam, the theme remained much the same. Shanmugaratnam too thought that monetary integration would be inappropriate. “Asia’s strength is its diversity,” he insisted. “That same diversity militates against monetary integration” (as quoted by Primosac 2006). *Plus ça change, plus ça la même chose.*

The reason for the resistance to a monetary union is simple. A government’s monopoly control of the money supply is a source of great power, as I have noted elsewhere (Cohen 1998). East Asian governments, with the exception of the special cases of Brunei and Hong Kong, have shown no inclination to relinquish that power easily. The idea of currency unification may hold a certain appeal as a long-term goal, at least for some, but for the foreseeable future it is fated to remain a non-starter.

A dollar standard

A third possibility, an interior solution between the corners, would be to establish a formal dollar standard for the region – a common peg linking all of the region’s currencies to a dollar anchor. The approach has been vigorously promoted by economist Ronald McKinnon (2005). Since most East Asian currencies already share a strong affinity for America’s greenback, McKinnon argues, why not take the next step and make the relationship official? A dollar standard, based on a conventional soft peg, would be far less demanding than a monetary

union, requiring little in the way of formal institutions or surrender of monetary sovereignty. Yet it would offer all the advantages of more direct exchange-rate harmonization. In particular, by making a common dollar peg every economy's default position, it would reduce the risk of turbulence in the event of a dollar crisis. Moreover, the approach would have the virtue of building on traditional regional practice rather than defying it.

But that would also be its vice, since it would preserve and perhaps even amplify the very fragilities that got East Asia into trouble once before. A dollar standard, McKinnon contends, would encourage more foreign borrowing. But that was precisely what led to the massive currency and maturity mismatches that made life so difficult after the Fall of the Baht. Formal dollar pegs would offer the same tempting target for speculators should new real misalignments emerge. They would also leave the region prey to the same outer exchange-rate problem. Even McKinnon concedes that an Asian dollar standard could not survive without a parallel agreement by Japan and the United States to stabilize the yen-dollar rate. East Asian governments, as noted, have taken their cue from the experience of 1997-98 to try to moderate such risks, by eschewing *de jure* targets and, at times, by loosening the dollar relationship. There is little evidence that they might now be prepared to reverse course in a way that, once again, could leave them exposed to financial fragility.

Basket pegging

A fourth possibility, an alternative interior solution long advocated by economist John Williamson (1999, 2005), would be some form of common basket peg for East Asia's currencies.

Typically, this means an “external” basket. Rather than link to the dollar alone, as McKinnon would have it, regional monies would be moored to a weighted average of several major outside currencies. Basket pegging is expressly intended to address the outer exchange-rate problem intrinsic to a single currency peg. Interventions would stabilize exchange rates in effective terms, minimizing vulnerability to fluctuations between the greenback and the currencies of other important trading partners. The benefits of exchange-rate harmonization would be gained without the disadvantage of tying the region’s fate to a single anchor. In Williamson’s words: “The object of the change would simply be to create an expectation that... variations in the exchange rates among the industrial countries would no longer have major impacts on the relative competitive positions of the East Asian countries” (Williamson 1999, 342).

In other respects, however, the option would share the same drawbacks as a dollar standard, including in particular the same temptation to speculators to exploit any real misalignments that might emerge. Moreover, grave difficulties could be encountered in designing a basket that might suit the circumstances of all economies in the region. For example, should Japan’s yen or China’s yuan be included in the basket, alongside the dollar and other logical candidates like the euro and sterling? Japan and China are both major markets for other economies in East Asia. But if either of their currencies were included in the basket, they would by definition be excluded from participating in the common peg. A wedge, therefore, could be driven between their exchange rates and the exchange rates of their smaller neighbors, which over time could affect competitive relationships. On the other hand, if their currencies were excluded from the basket so they could share in the common peg, the outer exchange-rate problem would no longer be effectively eliminated, since the yen or yuan could still fluctuate

markedly in relation to the basket's components. Similarly, it would be challenging, to say the least, to find a single set of weights for the basket currencies that would satisfy all the governments concerned.

The possibility of basket pegging is currently a focal point for discussion in East Asia, with official studies being commissioned in several countries. Because of the many difficulties involved, however, the probability that a common peg could be negotiated any time soon seems virtually nil. The option requires a good deal more commitment to regional solutions than appears evident in the area at present.

An Asian Currency Unit

Fifth, there is the possibility of an Asian Currency Unit of some kind, inspired by Europe's earlier experience with the European Currency Unit (ECU). The ECU was first defined in 1974 as a basket of currencies of the members of the European Community (as the European Union was then known) for purposes of Community accounting. By analogy, an ACU would be defined as a basket of East Asian currencies, an "internal" basket that might eventually provide a bridge to a common currency for the region. This idea too has become a focal point for discussion and has been actively promoted by the Asian Development Bank (ADB) as a useful first step toward exchange-rate harmonization. In May 2006, the approach was formally endorsed by the Finance Ministers of China, Japan and Korea in a joint statement (Giridharadas 2006).

How useful would an ACU be? Much depends on how ambitious regional governments wish to be. What the ADB and trio of Finance Ministers apparently have in mind is something limited to an accounting function, as was the ECU. Such a modest initiative might be politically feasible, but its impact would be correspondingly slight. If they want to heighten the ACU's impact, East Asian governments would have to go further – to encourage its use not only as a unit of account but for other monetary purposes as well. That would mean, for example, actively promoting the development of markets for privately issued ACU-denominated debt, in order to cultivate the unit's role as a store of value. It would also mean establishing of an efficient clearing and settlement system for ACU claims and perhaps even endowing the ACU with legal-tender status, to encourage its use as a medium of exchange. In effect, it would mean creating a parallel currency that would circulate alongside national currencies and compete for the favor of market actors.

The idea of a parallel currency has been seriously mooted by Eichengreen (2006), evidently as a second-best alternative should East Asia prove resistant to his preferred solution of free floating. But can anyone really imagine governments in the region creating a potentially attractive rival to their own state-sanctioned monies? The same conditions that are needed for a successful monetary union are demanded by a parallel currency as well; they are equally unlikely to be satisfied any time soon. This option too, for the foreseeable future, is fated to remain a non-starter.

Monetary-policy coordination

Finally, there is the possibility of some form of direct monetary-policy coordination within the present constellation of soft pegs, as advocated recently by a team of regional specialists led by economist Hans Genberg (Genberg *et al.* 2005). If the risk of turbulence cannot be suppressed via reform of ERRs, perhaps it can be subdued instead by some kind of agreement, formal or informal, to collaborate in setting and implementing domestic policy. An institutional framework might be constructed to promote regular consultations and exchanges of information. Monetary authorities might thus be able to avoid new real misalignments by adopting common targets for inflation and credit expansion. Such an approach would hardly be foolproof, of course; in the absence of firm constraints on government autonomy, defection or free riding would always remain a possibility. But at least the chances for monetary stability would be enhanced as compared with totally decentralized decision-making. In Genberg's words: "The key is to allow each central bank to implement its own monetary policy... but to agree on a consistent objective to be pursued by all" (Genberg 2006, 16).

The advantage of the coordination approach is its consistency with the region's traditional pragmatism in policymaking. The process can be pursued experimentally and incrementally, gradually building the institutions and mutual trust needed for more ambitious initiatives. The question, however, is whether even so limited an infringement on national sovereignty is plausible in current circumstances. As I wrote in 1993, several years before the Fall of the Baht, "a serious and sustained commitment to monetary cooperation requires a real sense of *community* among the countries involved" (Cohen 1993: 155). I suggested then that there seemed little evidence of such a sense of common identity in the East Asian region. Ten

years after the events of 1997-98, the necessary degree of mutual commitment still seems most conspicuous by its absence.

Monetary cooperation is not impossible, of course. But as I also wrote back in 1993, it is more likely to emerge during a crisis than before it. At times of speculative pressure, when the benefits of stabilization become paramount, governments may be willing to enter into policy compromises in an effort to restore market confidence. But once the sense of crisis subsides, the desire to exercise monetary autonomy tends to reassert itself, encouraging defection and free riding. The result is a cyclical pattern that provides little assurance of effective coordination over time.

CONCLUSION

So where does all this leave exchange-rate regimes and alignments in East Asia?
Answer: Pretty much where they were a decade ago, before the Fall of the Baht. Currency strategies remain diverse but, in most cases, little changed. Exchange rates are still managed pragmatically in service to broader development goals, and the likelihood of radical reforms is still close to nil. Continuity remains the name of the game. Whether this will be enough to cope with the pressures that might emerge, should the Bretton Woods II pattern prove to be unsustainable, is anyone's guess.

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