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 paper focuses on exchange-rate regimes and alignments in the region. The aim of the paper 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 crisis? (2) What explains currency strategies in the period since 1997-98? (3) What is the outlook for the region’s exchange rates in the future? Evidence suggests that the role of exchange rates 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 continuity of practice in most regional economies. ERRs are seen as instrumental rather than an end in themselves and have been adjusted only where change seemed appropriate to serve broader developmental goals. Governments have resisted and are likely to continue to resist more radical reforms despite a plethora of suggested alternatives.
MISS PRISM. Cecily, you will read your Political Economy in my absence. The chapter on the Fall of the Rupee you may omit. It is somewhat too sensational. Even these metallic problems have their melodramatic side.

CECILY. *(Picks up books and throws them back on table.)* Horrid Political Economy!

— Oscar Wilde, *The Importance of Being Earnest*

If Oscar Wilde were writing today, might he have substituted the Thai baht for the Rupee in this amusing exchange between Miss Prism and Cecily? 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 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 indeed sensational and could even be described as melodramatic.

A decade after the Fall of the Baht, what has been learned? This paper focuses on exchange-rate regimes and alignments in East Asia. For the purposes of the paper, 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 paper 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 paper 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 that may be observed in individual countries.

The main analysis then follows in three subsequent sections, addressing a trio of critical questions: (1) What role did exchange rates play in East Asia’s crisis? (2) What explains government choices in the period since 1997-98? (3) What is the outlook for the region’s currency strategies in the future? Evidence suggests that the role of exchange rates 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 continuity of practice in most regional economies. ERRs are seen
as instrumental rather than an end in themselves and have been adjusted only where change seemed appropriate to serve broader developmental goals. Governments have resisted and are likely to continue to resist more radical reforms despite a plethora of suggested alternatives.

THE CORE ISSUE

The core issue for the governments of East Asia, as for governments everywhere, 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 is key to understanding a government’s choice of exchange-rate regime. The challenge is to fashion an exchange-rate regime that will neither encourage adverse speculation nor compromise management of the domestic economy. Much depends on how the choice of ERR is framed.

In earlier years, the choice 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 an increasingly 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.

In practice, of course, contingent rules are not truly discredited, for the simple reason that in an imperfect world there is no perfect solution. The bipolar view implicitly assumes that governments are unwilling under any circumstances to pay the price of coping with occasional speculative crises. In effect, no tradeoff is considered possible between currency stability and other objectives of policy. But that is a political judgment – and highly dubious, at best. The reality is that tradeoffs are made all the time when exchange-rate policy is decided. No option is ruled out a priori. As Jeffrey Frankel has written: “Neither pure floating nor a currency board 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, a dimension of exchange-rate policy that tends to be discounted in conventional economic discourse. The closest that standard analysis comes to addressing the political dimension is in the well known theory of optimum currency areas (OCAs), which directly considers the policy interests of government in alternative ERRs. Efficiency benefits of a hard peg or equivalent are compared with the potential costs of doing
without a flexible exchange rate. In the language of the Unholy Trinity, governments must decide between exchange-rate stability or monetary-policy autonomy.

A diverse range of variables is identified in OCA theory, representing characteristics of economies that might arguably affect the magnitude of prospective losses through their influence on either the severity of payments disturbances or the ease of needed adjustments. Included among these so-called “country characteristics” are wage and price flexibility, labor and capital mobility, commodity diversification, geographic trade patterns, size and openness of economies, levels of development, inflation trends, and the nature, source, and timing of potential economic shocks. Politics in this context, however, takes on an extraordinarily narrow meaning, since policymakers are assumed to be concerned with little more than maximizing output and minimizing inflation in an open economy. Broader political considerations are most notable for their absence.

In fact, broader political considerations enter in two ways. First, as Jeffrey Frieden (1993: 140) has noted, “domestic distributional considerations are also central to the choice of exchange rate regimes.” The policy calculus is obviously affected by domestic politics -- the tug and pull of organized interest groups of every kind, whether sectoral, regional, or partisan. The critical issue is familiar: Who wins and who loses? The material interests of specific constituencies are systematically influenced by what a government decides to do with its money. Policy strategies are bound to be sensitive to the interplay among domestic political forces as well as to the institutional structures through which interest-group preferences are mediated.

Second, the utility function of policymakers obviously includes more than just macroeconomic performance. As a practical matter, sovereign governments also worry about many other things, including economic and security relations with other states. Not least, governments worry about their own policy autonomy; that is, their scope for discretion to pursue diverse objectives in the event of unforeseen developments, up to and including war. Key here is the availability of seigniorage – a government’s “revenue of last resort.” The more tightly a currency is pegged, the less room policymakers have to resort at will to money creation to augment public expenditures. Monetary firmness is gained, but at a loss of fiscal flexibility. Certainly it is not wrong to attach importance to a reduction of exchange-rate uncertainty in hopes of promoting higher trade and investment and perhaps lower interest rates. But in an insecure world, governments may be forgiven for attaching importance to currency flexibility too, as a defense against political uncertainty. Policy strategies are bound to be sensitive to the interplay among such considerations as well.

Given the multiple considerations involved, economic as well as political, it is obvious that there can be no magic bullet – no single “first-best” policy that would be the most suitable option for all economies. Quite the opposite, 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. The tradeoffs that states make must accommodate their own unique needs and circumstances. Each government is condemned to optimize on its own.

**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 in 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 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, relatively 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, currency 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.

Official exchange-rate policies are defined by the pronouncements of central banks or their equivalent. For all the economies of the region other than Taiwan, formal (de jure) ERRs are conveniently reported on a regular basis by the International Monetary Fund (IMF) in its *Annual Report on Exchange Arrangements and Exchange Restrictions*, derived from statements by each economy’s central monetary authority. The latest data available from the Fund are for 2005 (IMF 2005). For Taiwan, which is not a member of the Fund, information must be obtained directly from that island’s central bank, the Central Bank of China. A summary of official policies for the period 1996-2005 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 exchange 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 announced 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. These include a revised system developed by the IMF itself (IMF 1999, 2003) as well as independent studies by *inter alia* Reinhart and Rogoff (2004), Shambaugh (2004), and Levy-Yeyati and Sturzenegger (2005). Among these, the most useful for this paper’s purposes is the study by Levy-Yeyati and Sturzenegger (hereafter LYS). The LYS classification scheme extends further
than any other study, 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:

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

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.

At the opposite extreme are Japan and Taiwan, which for the most part allow their currencies to float freely. Korea and the Philippines also claim to maintain independent (clean) floats but in fact intervene actively to manage their exchange rates.

Some 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 – actually appear to fix their rates or operate a crawling peg, suggesting a marked “fear of floating.” Until 2002 the same was also true 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 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 in the East Asian region is matched by their continuity in individual economies. Changes have occurred, of course. But contrary to the bipolar view, there has been no broad trend toward one corner solution or the other. In fact, as Table 1
demonstrates, radical change has been relatively rare and has not always been in the direction predicted by the bipolar view.

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.

In fact, 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. 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 study, 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. Of the three countries that officially claim to have adopted a policy of floating since the crisis, two (Korea and Myanmar) in practice still keep their exchange rates as stable 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 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 and political as well as economic. Of particular importance were critical defects in the development model being followed at the time 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’s 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 for most of the region’s exporters. Parallel links to the greenback served indirectly to harmonize exchange rates, thus stabilizing relative competitive positions in East Asia’s biggest foreign market.

Little risk was involved in relying on a dollar anchor so long as America’s currency remained comparatively weak, as it did in the early 1990s. A cheaper greenback meant greater competitiveness for East Asian exports in third markets, such as Europe or Canada. But once the dollar began to strengthen in the mid-1990s, growth of export revenues quickly decelerated, worsening trade balances, particularly for 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 safe. 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, 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. Following a brief post-crisis hiatus, the dollar’s predominant weight in East Asian currency baskets has largely returned to its pre-crisis levels, ranging from about 70 percent for Singapore to above ninety percent in Malaysia, the Philippines, and Vietnam (Volz 2006; see also McKinnon 2005). Most currency strategies in the region are still targeted closely on the dollar relationship.

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 conventional soft peg without dissembling 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 so-called Asian Bond Market Initiative [Amyx paper?] – most external borrowing in the region continues to be denominated in foreign currency. East Asia still suffers from “original sin.” Soft pegs, therefore, even if no longer de jure, could once again invite a dangerous build-up of unhedged currency mismatches. Worse, serious damage could be done to government reputations, despite 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 continues to compound 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 any single money such as 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,” gaining 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, where far more is 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 government 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 difficult. Poor economic prospects translate directly into poor career prospects for those in positions of authority.

In turn, growth demands a continued expansion of exports, particularly to the major markets of North America and Europe, 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 or the tax revenues it makes available for building infrastructure or improving social benefits. It is also prized in domestic political terms, for the material benefits it brings to specific, influential constituencies. States may have moderated some of the more egregious manifestations of crony capitalism since the region’s crisis.[MacIntyre paper?] But after decades of export-led development, 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 interest groups happy.

Finally, trade expansion is valued in national-security terms, for the contribution it makes by 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 protection.

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 most of the region’s 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 sustain a stable exchange-rate relationship with the greenback, in order to maximize sales opportunities. It also helps that the dollar is still the currency of choice for trade invoicing in many other parts of the world as well as for all commodity markets, including most critically the global energy market; and is also the most
convenient vehicle for interbank foreign-exchange transactions. 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 a bit when conditions warrant (Eichengreen 2004: 63). 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.

**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? Certainly there is no lack of candidates; myriad alternatives have been proposed in the years since the crisis. Broadly, five possibilities have dominated discussion: free floating, currency unification, a dollar standard, basket pegging, or a so-called Asian Currency Unit (ACU). All have their advantages. But each has disadvantages as well – not least, in most cases, a distinct lack of political feasibility. Except possibly for a modest version of an ACU, none is apt to be adopted any time soon.

*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 development process that is so vital to their legitimacy. Exchange-rate stability simply represents a lower order of priority.

Admittedly, there is a downside to floating. Unmanaged exchange rates could gyrate unpredictably, disrupting exports and, by implication, growth. Among economists, there is now a general consensus that exchange-rate variability has a negative effect on trade. But the magnitude of the effect remains uncertain and, in most cases, appears to be relatively small (Eichengreen 2004: 51-52). Moreover, as financial markets in the East Asian region continue to develop, opportunities for hedging can be expected to become both more plentiful and less expensive. The risk of volatility is real, but neither should it be exaggerated.

Nor, we are told, should we ignore the fact that there is also an upside – the role that a floating rate can play in promoting rapid adjustment to changing economic circumstances. As Eichengreen, a fan of floating, puts it: “A fast-moving global economy places a premium on economic flexibility. Exchange rate flexibility is one source of economic flexibility. Changes in exchange rates are useful for maintaining and restoring competitiveness when economic conditions change” (Eichengreen 2004: 53). There may be more virtue to an independent float than commonly thought.

East Asian governments, however, appear to be little convinced by such positive spin. Of much greater concern to them is the risk that disparate exchange-rate movements could have an unwarranted impact on competitive relationships in the region. They, as well as anyone, know how much individual exchange rates 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. After Ronald Reagan was elected President of the United States, America’s greenback appreciated by as much as sixty percent in under four years, only to drop by a comparable amount in the next two years following the famous Plaza Accord of mid-1985. Likewise, in its short existence since 1999, the euro has swung from a low of 83 cents (U.S.) in 2001 to a high above $1.35 in 2004. 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 a tolerance for that much uncertainty. Quite the opposite, in fact. “Fear of floating” is deeply institutionalized in East Asia. Even the Japanese, whose yen has been formally floating for decades, intervene frequently to exercise some degree of control over their exchange rate, particularly in relation to the greenback. How else, for example, can one explain the Bank of Japan’s immense accumulation of dollars in recent years, now in excess of $800 billion? A switch to unrestrained flexibility, leaving the determination of rates 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**

So 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 (Madhur 2004; 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 greater insulation against future 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 also leave competitive relationships in third markets, such as the United States, undisturbed. It would be easier to manage than a diverse collection of national currencies of differing degrees of credibility. And it would enhance East Asia’s voice and influence in international monetary forums, not least at the International Monetary Fund. No wonder that some have flatly predicted the coming of an Asian Monetary Union (AMU) in the not-too-distant future (Walter 1998).

But is this 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. ASEAN would seem to be the closest equivalent. Its ten members are in the process of building a free-trade area, first agreed in 1992. An AMU, like EMU, might seem a logical next step. But not even ASEAN’s most ardent admirers think it likely that a monetary merger could be negotiated any time soon. The reasons are both economic and political.

Economically, the ASEAN partners are an obviously diverse lot in terms of structure and development, ranging from modern high-tech Singapore and emerging manufacturing centers like Malaysia and Thailand to rural and still primarily agrarian economies such as Cambodia, Laos, and Myanmar. Trade relations tend to be diversified geographically, with intra-group trade still relatively limited, and there is no evidence of significant convergence in terms of either economic shocks or macroeconomic performance. Econometric studies confirm that the group remains far from anything that might be described as an optimum currency area (Eichengreen and Bayoumi 1999).

Even more critically, ASEAN is still at an early stage of evolution as a political community. For all their protestations of amity, member governments remain noticeably distrustful of one another and place a high premium on preservation of as much national sovereignty as possible. In fact, the group is rife with historical antagonisms, ethnic and cultural conflicts, and border disputes. Unlike Europeans, East Asians are as yet unwilling to pay even lip service to the notion of “an ever closer union” among their peoples. Most, having only
recently emerged from colonial status, are more intent on separate state-building than on promoting regional solidarity. Though efforts to promote collective interests have not been absent, ASEAN governments for the most part prefer to rely primarily on informal arrangements and market processes rather than on formal institutions to pursue their objectives.

But if not ASEAN, who then might be the economies to catalyze the creation of AMU? Conceivably, one or more sub-groups of ASEAN could take the lead – say, an initiative combining the more advanced economies of Malaysia, Singapore, and Thailand. Structural differences among the three are smaller than within the group as a whole, and evidence suggests that they come closer to meeting the criteria of an optimum currency area (Eichengreen and Bayoumi 1999). But even these three remain far apart in political terms; and in any event it is difficult to imagine that they might undertake any joint project -- particularly in a matter as vital as money -- that would leave the rest of their ASEAN partners behind.

Alternatively, it might perhaps be possible to build on the “ASEAN+3” formula established by the Chiang Mai Initiative. The advantage is that the broader group would include two countries, China and Japan, who separately or together could provide the leadership needed get such a project under way. The disadvantage is that neither Beijing nor Tokyo has shown the slightest interest in sharing monetary sovereignty with the other, let alone with a diverse collection of smaller neighbors. Japan has made clear that it would prefer to create an exclusive bloc based on the yen, while China, with its own great-power aspirations, can be expected to resist any bid by Tokyo for local monetary hegemony. Moreover, suspicions of both powers remain widespread throughout the region. Wariness about the Japanese goes back to Japan’s attempts during the interwar period to create a Greater East Asia Co-Prosperity Sphere, which most Asians remember as an exploitative and demeaning relationship. Fears of future domination by a giant, rapidly growing China are equally strong. And of course there is also the ever-festering problem of Taiwan and how that sizable economy would fit into the picture.

Whatever the combination of economies that might be involved, therefore, 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, even after the Fall of the Baht. The reason 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). Most East Asian currencies already share a strong affinity for America’s greenback, McKinnon argues. So 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. Moreover, the
approach would have the virtue of building on traditional regional practices rather than defying them.

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. Likewise, formal dollar pegs would offer the same tempting target for speculators and leave the region prey to the same outer exchange-rate problem. Regional governments, as indicated, took their cue from the crisis to try to moderate such risks, by eschewing *de jure* targets and, at times, by loosening the dollar relationship. There is little evidence to suggest that they might now be prepared to reverse course in a way that could, once again, leave them exposed and vulnerable to crisis.

**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. Basket pegging is expressly intended to address the outer exchange-rate problem intrinsic to a single currency peg. Rather than link to the dollar alone, as McKinnon would have it, regional monies would be moored to a weighted average of several major currencies. 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 temptations to speculators. Moreover, grave difficulties could be encountered in designing a basket that would 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’s components that would satisfy all the governments concerned.

Because of difficulties like these, the probability that a common basket peg could be negotiated any time soon seems virtually nil. The option requires a good deal more good will and commitment to regional solutions than appear evident in East Asia at present.
An Asian Currency Unit

Finally, 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, which might also serve an accounting function and could perhaps eventually provide a bridge to a common currency for the region. The idea has been actively promoted by the Asian Development Bank (ADB) as a useful first step toward exchange-rate harmonization and in May 2006 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 want 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. While the ECU was formally adopted by European institutions as a unit of account, it never gained much popularity in the private sector and was only rarely used by traders or investors. It also played little role in the transition to EMU and was even dropped from consideration when it came time to give a name to Europe’s new money, which of course became known as the euro. An ACU qua unit of account would most likely turn out to be no less innocuous.

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.

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.
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