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Crisis as Catalyst

Asia's Dynamic Political Economy

EDITED BY

Andrew MacIntyre, T. J. Pempel,
and John Ravenhill

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Contents

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After the Fall

East Asian Exchange Rates since the Crisis

Benjamin J. Cohen

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. Whereas 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 chapter focuses on exchange rate regimes and alignments in East Asia. 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 chapter 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 set the stage for the analysis. The first section reviews the core factors involved in the choice of an exchange rate regime (ERR), including political and economic considerations. All governments face a number of critical trade-offs in framing their currency strategies; there is no obvious first-best policy for an 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. Just as they did before the crisis, most governments continue to practice some form of pegging with a heavy emphasis on stability vis-à-vis the U.S.

dollar. Subsequent sections address a trio of critical questions: (1) What role did exchange rates play in the East Asian crisis? (2) What explains currency strategies in the period since 1997–98? (3) What is the outlook for future ERRs in the region?

Evidence suggests that the role of ERRs in the crisis was more indirect than direct; precrisis 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 to reduce vulnerability to future shocks—but mainly in related policy areas rather than in the ERRs themselves. The reason is that ERRs are seen as instrumental, not as an end in themselves, and therefore have been adjusted only when change seemed appropriate to serve broader developmental goals. Governments have resisted and are likely to continue to resist more radical innovations in their currency strategies. Despite the popular enthusiasm for new regional initiatives that was prompted by the crisis, authorities have shown little interest in any form of institutionalized exchange rate commitment that would limit their policy autonomy.

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 allow it to 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, and 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 puts 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 trade-off is considered possible between currency stability and other policy goals. But that hardly seems plausible. In reality, trade-offs are made all the time when currency strategy is decided. No option is ruled out a priori, including

contingent rules. As Jeffrey Frankel writes, “Neither [corner solution] sweeps away all the problems that come with modern globalized financial markets. . . . Optimization often . . . involves an ‘interior’ solution” (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 the management of the national economy. Sensitivity to external shocks is heightened, making the country hostage to policies made elsewhere. Floating, conversely, preserves more of the capacity of a government to manage macroeconomic performance, but it does so 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 is 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. Although there have been many empirical studies of the determinants of ERR choice in recent years by both economists and political scientists, the results have been inconclusive at best and often inconsistent (Rogoff et al. 2004, 17–20). In the end, the trade-offs 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 trade-offs 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 regional 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 appears 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 1996–2006, as reported by the IMF, is provided in column 1 of table 2.1.

Table 2.1 East Asian exchange rate regimes^a

	Year	(1) De jure regime	(2) De facto regime
Brunei	1996–2004	Currency board arrangement	Fixed
	2005–2006	Currency board arrangement	—
Cambodia	1996–1998	Managed floating	Float
	1999–2001	Managed floating	Dirty crawling peg
	2002	Managed floating	Inconclusive
	2003	Managed floating	Dirty crawling peg
	2004	Managed floating	Inconclusive
	2005–2006	Managed floating	—
China	1996–1998	Managed floating	Fixed
	1999–2004	Conventional pegged arrangement; flexibility limited to a single currency	Fixed
	2005–2006	Conventional pegged arrangement; flexibility limited with reference to a basket of currencies	—
Hong Kong	1996–2004	Currency board arrangement	Fixed
	2005–2006	Currency board arrangement	—
Indonesia	1996–1997	Managed floating	Dirty crawling peg
	1998	Independently floating	Dirty float (outlier)
	1999	Independently floating	Dirty crawling peg
	2000	Independently floating	Float
	2001	Independently floating	Dirty crawling peg

	Year	(1) De jure regime	(2) De facto regime	
Japan	2002–2004	Managed floating	Float	
	2005–2006	Managed floating	—	
	1996–2004	Independently floating	Float	
Korea	2005–2006	Independently floating	—	
	1996	Managed floating	Fixed	
Laos	1997	Managed floating	Dirty crawling peg	
	1998	Independently floating	Dirty crawling peg	
	1999–2004	Independently floating	Fixed	
	2005–2006	Independently floating	—	
	1996	Independently floating	Inconclusive	
	1997–1998	Managed floating	Dirty crawling peg	
Malaysia	1999	Managed floating	Dirty float	
	2000–2002	Managed floating	Float	
	2003	Managed floating	Dirty crawling peg	
	2004	Managed floating	Float	
	2005–2006	Managed floating	—	
	1996	Managed floating	Dirty crawling peg	
	1997	Managed floating	Float	
	1998	Managed floating	Dirty crawling peg	
	1999–2004	Conventional pegged arrangement; flexibility limited to a single currency	Fixed	
	2005–2006	Managed floating	—	
Myanmar	1996–1998	Pegged to a composite of currencies; officially pegged to the SDR	Fixed	
	1999–2001	Conventional pegged arrangement; a basket of currencies other than SDR	Fixed	
	2002–2004	Managed floating	Fixed	
Philippines	2005–2006	Managed floating	—	
	1996	Independently floating	Fixed	
	1997–2003	Independently floating	Float	
	2004	Independently floating	Dirty crawling peg	
	2005–2006	Independently floating	—	
Singapore	1996	Managed floating	Dirty crawling peg	
	1997–1998	Managed floating	Float	
	1999–2001	Managed floating	Fixed	
	2002	Managed floating	Dirty float	
	2003–2004	Managed floating	Fixed	
	2005–2006	Managed floating	—	
Taiwan	1996–2004	Independently floating	NA	
	2005–2006	Independently floating	—	
Thailand	1996	Pegged to a composite of currencies	Inconclusive	
	1997	Pegged to a composite of currencies; a basket of currencies other than SDR	Dirty crawling peg	
	1998	Managed floating	Dirty crawling peg	
	1999–2001	Independently floating	Float	
	2002–2004	Managed floating	Float	
	2005–2006	Managed floating	—	
	Vietnam	1996–1999	Managed floating	NA
		2000–2001	Pegged exchange rate within horizontal bands	NA
2002–2004		Managed floating	NA	
2005–2006		Managed floating	—	

Sources: International Monetary Fund; Annual Report on Exchange Arrangements and Exchange Restrictions, 1996–2006. Central Bank of China (www.cbc.gov.tw); Levy-Yeyati and Sturzenegger (2005).

^a NA, not available; SDR, special drawing right.

Formal policy, however, tells only 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 (2002) 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 my purposes are the estimates of Eduardo Levy-Yeyati and Federico Sturzenegger (2005). The Levy-Yeyati and Sturzenegger classification scheme extends through 2004, further than any other study presently available. It also includes the largest number of the economies in the region, thirteen out of fifteen (all but Taiwan and Vietnam).

Levy-Yeyati and Sturzenegger use a cluster analysis 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:

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 types may be regarded as closely related versions of soft pegs; the last two types may be regarded as alternative versions of floating. A comparison of de facto ERRs with de jure arrangements, based on Levy-Yeyati and Sturzenegger, is provided in column 2 of table 2.1.

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 important, 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. The Brunei currency board, which has existed since 1967, is based on the Singapore dollar. The Hong Kong currency board, dating from 1983, anchors on the U.S. dollar. In 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. Taiwanese interventions are limited mainly to “leaning against the wind”; Japan, after a period of massive intervention in 2003–4, 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 they actively manage their exchange rates. Levy-Yeyati and Sturzenegger classify the de facto regime of Korea 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 Vietnam) 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 of Indonesia, although in the most recent period its behavior seems to have moved more closely in line with its 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 the Chinese yuan was formally switched in 2005 to a basket of currencies. Until 2005, Malaysia also maintained a peg anchored to the U.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 2.1 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 with currency boards (Brunei and Hong Kong), three of the independent floaters (Japan, Philippines, and Taiwan), and five with managed floats (Cambodia, Indonesia, Malaysia, Singapore, and Vietnam). 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, whereas 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 and Thailand in 1998. Korea shifted from managed flexibility to an independent float in 1998. The Malaysian 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 data provided by Levy-Yeyati and Sturzenegger (2005). Of the thirteen countries included, six show no change of actual practice (Brunei, China, Hong Kong, Japan, Korea, and Myanmar), whereas 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, whereas 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 expected.

Quite the opposite, in fact. Whether we judge from the formal pronouncements or from Levy-Yeyati and Sturzenegger's 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 the 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 ERRs in the region 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" (1999a, 4), involving forces both foreign and domestic, political and 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. Although this 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 the 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 the 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 as 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 economies of the region, 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 John Maynard Keynes called the self-destructive "animal spirits" of entrepreneurs and financiers. As Eichengreen comments, "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" (1999, 163). The easy availability of foreign capital led to exuberant credit expansion, dangerous asset bubbles in real estate and equities, and overinvestment in productive capacity—all factors that contributed to the severity of the crisis once the Thai baht fell. In effect, the ERRs in the region 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 regional 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 the U.S. greenback. Even ostensible free floaters such as Japan and 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 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 exporters in the region. A stable link to the greenback not only facilitated sales to U.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, the growth of export revenues quickly decelerated, worsening trade balances and bringing misalignments to the surface. The impact was particularly sharp in countries such as Indonesia, Malaysia, and Korea. Worst hit was Thailand, whose current-account deficit by the start of 1997 had swollen to nearly 8 percent of 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 and 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 the East Asian experience a decade ago. If the regional 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 the U.S. greenback remains the dominant influence on exchange rates. According to one representative study, the predominant weight of the dollar in East Asian currency baskets, following a brief postcrisis hiatus, has largely returned to its precrisis levels, ranging from about 65 percent for Singapore to above 90 percent in Cambodia, Laos, Malaysia, Myanmar, the Philippines, and Vietnam (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 on 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, whereas 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 Initiatives (see Jennifer Amyx, chap. 4 in this volume)—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 buildup 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” (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” (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 regional trade competitiveness hostage to the fortunes of the U.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, 183–84). In the most recent years, as in the early 1990s, the outer exchange rate problem has actually worked to the advantage of the region. With the greenback once more weakening under the pressure of accelerating U.S. 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 fate of the region 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 government survival or the 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 because East Asian governments still rely most heavily on the 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 as long as governments remain committed to the 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 the dollar anchor seem unreasonable, given the still central importance of the U.S. market for regional exporters. With 30 percent of world GDP, the United States remains the consumer of last resort for the ever-growing output of East Asia. It hardly seems irrational, therefore, for East Asia to seek to preserve a stable relationship with the greenback to sustain sales. In fact, governments have intervened heavily to keep their exchange rates from appreciating significantly in terms of the dollar, accumulating record amounts of reserves in the process—more than \$800 billion in China and Japan, and 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 the 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 the results of the learning process show up mainly in related policy areas rather than in the ERR itself. Reducing vulnerability to future shocks has obviously become a priority, as the editors of this volume emphasize. But recognizing that exchange rates were at best a catalyst, not a direct

cause of the crisis, East Asian nations have directed most of their effort elsewhere, toward reducing the many other fragilities that turned the fall of the baht into such a disaster.

Internally, reforms have been undertaken to improve the prudential supervision of financial markets (Natasha Hamilton-Hart, chap. 3 in this volume). Externally, the enormous new reserve stockpiles in the region, 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 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, chap. 4 in this volume).

In short, there is indeed method in the regional 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 trade-off among policy objectives?

Much depends, of course, on the nature of the threat. Of most salience today is the continued East Asian allegiance to dollar pegging, which for the region as a whole has produced massive trade surpluses matched by corresponding U.S. deficits, a pattern that has been described as a revived Bretton Woods system or Bretton Woods II (Dooley, Folkerts-Landau, and Garber 2003). Much doubt exists about whether the Bretton Woods II pattern is sustainable (Eichengreen 2007). The question on everyone's mind is: What happens if the U.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), and 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 important, floating could help forestall a buildup of real misalignments, thus easing adjustment should the Bretton Woods II pattern prove unsustainable. Regional governments, however, appear to be 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 such as 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, the 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 seems an obvious solution because it would, *ex hypothesi*, eliminate all risk of exchange rate instability in the region. The idea is widely touted (Mundell 2004) and, following the crisis, was even endorsed as a “distinct possibility”

by the heads of government of ASEAN (Association of Southeast Asian Nations [ASEAN] 1999).

The reasoning is by analogy with the European Economic and Monetary Union (EMU). At the microeconomic level, a common currency like the euro would reduce transactions costs, thus encouraging intraregional 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, 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 despite widespread interest in the creation of new regional institutions. Ten years ago, just as the crisis was starting, Joseph Yam, head of the Hong Kong Monetary Authority, threw cold water on the idea when he delivered the prestigious Per Jacobsson Lecture at the annual meeting of the IMF. Regional monetary integration, he declared, "is inappropriate, at least for the time being" (Yam 1997, 21). A decade later, in another Per Jacobsson Lecture by Singapore Second Minister for Finance Tharman Shanmugaratnam, the theme remained much the same. Shanmugaratnam too thought that monetary integration was inappropriate. "Asia's strength is its diversity," he insisted; "That same diversity militates against monetary integration" (as quoted in Primorac 2006, 292). *Plus ça change, plus ça la même chose.*

The reason for the resistance to a monetary union is simple. Governmental 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 nonstarter.

A Dollar Standard

A third possibility, an interior solution between the corners, is to establish a formal dollar standard for the region, a common peg linking all of the currencies of the region to a dollar anchor. The approach has been vigorously promoted by economist Ronald McKinnon (2005). Because most East Asian currencies already share a strong affinity for the U.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, making a common dollar peg the default position of every economy 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 because 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 and 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 and long advocated by economist John Williamson (1999, 2005), is some form of common basket peg for East Asian currencies. Typically, this means an external basket. Rather than being linked to the dollar alone, as McKinnon would have them do, 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 fate of the region 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" (1999, 342).

In other respects, however, the option shares the same drawbacks as a dollar standard, including, in particular, the same temptation for 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 the economies in the region. For example, should the Japanese yen or Chinese yuan be included in the basket, alongside the dollar and other logical candidates such as the euro and pound 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 because the yen or yuan could still fluctuate markedly in relation to the basket 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 ACU of some kind, inspired by the earlier European 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 (Anand Giridharadas, "Asian Finance Ministers Talk of United Currency," *International Herald Tribune*, May 5, 2006, 12).

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 impact of the ACU, 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 role of the ACU 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 (2005), 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 nonstarter.

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 the 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" (2006, 16).

The advantage of the coordination approach is its consistency with the traditional regional 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, despite efforts to reduce vulnerabilities and build regional institutions. 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.

CHAPTER 3

Banking Systems a Decade after the Crisis

Natasha Hamilton-Hart

Banks and the Crisis

The banking industry can be seen as a principal culprit implicated in the financial crises of 1997–98 in that the lending behavior of banks directly contributed to an overindebted corporate sector vulnerable to exchange rate risks. To be sure, many problems besetting crisis-hit economies did not originate in the banking sector; but commercial banks and other financial intermediaries, both foreign and local, played a crucial role in translating a variety of underlying failings into the proximate cause of the crisis—the rapid expansion of credit, much of it foreign currency-denominated, followed by an abrupt reversal of lending (as discussed in Andrew MacIntyre, T. J. Pempel, and John Ravenhill, chap. 1 in this volume). To this extent, the crises suffered by Thailand, Korea, Malaysia, and Indonesia were similar; and the postcrisis trajectories of the banking systems in these countries, the subject of this chapter, can usefully be compared. Postcrisis changes in the Japanese banking system are also discussed here. Although Japan did not suffer a balance-of-payments crisis in 1997–98, long-standing problems affecting its domestic banking system came to crisis point during this period and its reform program shares many similarities with those pursued by the other crisis countries.

Postcrisis reforms in the banking sector in all these countries became a means for dealing with problems that stemmed from broader political economy conditions such as the relationship between business and government (e.g., corruption and cronyism) and issues relating to corporate structure and governance. Not only did the currency crises swiftly manifest themselves in the banking sectors of the affected countries but the extraordinarily expensive public bailouts to deal with bad debt, compensate