

Exchange Rate Policy Options for Post-crisis Southeast Asia: Is There a Case for Currency Baskets?

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1. INTRODUCTION

FOLLOWING the recent financial crises in Southeast Asia and elsewhere, the perennial issue of the exchange rate policy options for small and open developing countries has resurfaced. There seems to be a growing convergence of opinion that the need to depoliticise exchange rate movements, along with the frequency with which ‘soft pegs’ have been susceptible to speculative attacks in this era of escalating global capital flows, has increased pressure for developing countries to adopt corner solutions to exchange rates arrangements. In other words, according to many observers, the exchange rate option for developing countries boils down to one between flexibility, on the one hand, and credible pegging, on the other.¹ Countries are, however, advised to steer clear of arrangements that lie anywhere between these polar extremes (i.e. those in the ‘middle’) as they are seen as inherently unstable (Table 1). Thus, for instance, the recent Independent Task Force sponsored by the Council on Foreign Relations recommended that developing countries should ‘just say no to supporting pegged exchange rates’ (Council on Foreign Relations, 1999). In similar vein, Summers (1999) has proclaimed of exchange rate policy options:

There is no single answer, but in light of recent experience what is perhaps becoming increasingly clear – and will probably be increasingly reflected in the advice that the

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¹ Mussa et al. (2000) summarise the current economic environment facing developing and transition economies and their corresponding implications for the choice of exchange rate arrangements.

TABLE 1
Exchange Rate Regimes Ranged along the Continuum from Most Flexible to the Strongest Fixed-Rate Commitment

<i>Type</i>	<i>Definition</i>
<i>Flexible Corner</i>	
● Free floating	The absence of regular/systematic intervention in the forex market
● Managed/Dirty float	The absence of a specific target for the exchange rate
<i>Intermediate Regimes</i>	
● Target zone/band	A margin of fluctuation around some central rate
● Crawling peg	A pre-announced policy of devaluing 'a bit' each week
● Adjustable peg	Fixing the exchange rate, but without any open-ended commitment to resist devaluation or revaluation in the presence of a large balance of payments deficit or surplus
● Basket peg	Fixing not to a single foreign currency but to a weighted average of other currencies
<i>Fixed Corner</i>	
● Fixed peg	Commitment to undertake whatever forex market intervention needed to maintain prevailing rate, but not necessarily any institutional commitment to back the regime
● Currency Board	Three defining characteristics: fixing not just by policy but by law; backing increases in the monetary base one-for-one with forex reserves; and allowing balance of payments deficits to tighten monetary policy consequently adjusting spending automatically
● Monetary Union	The adoption of a foreign currency as legal tender. Includes the special case of official dollarisation

Source: Adopted from Frankel (1999).

international community offers – is that in a world of freely flowing capital there is shrinking scope for countries to occupy the middle ground of fixed but adjustable pegs.

In line with these recommendations, the IMF data on exchange rate arrangements in developing countries reveals a *de jure* trend away from soft peg arrangements. For instance, the share of countries officially classified as having a pegged exchange rate regime dropped from 97 per cent in 1970 to just 11 per cent by 1999 (Table 2). This phenomenon has been colourfully described in various places as the 'corners hypothesis', the 'hypothesis of the vanishing intermediate regime', the 'missing middle', the 'hollowing of the middle' and the 'law of the excluded middle'.

This paper takes issue with this popular – 'one-size-fits-all' – prescription of exchange rate arrangements for developing countries in general. Advocates of corner solutions have been insufficiently sensitive to the drawbacks of such arrangements. It is wrong merely to assume that the best regime will be either flexible exchange rates or 'super fixes', without a proper consideration of problems associated with each of these regimes. While it is understandable that

TABLE 2
IMF Exchange Rate Classification

Year	<i>Per Cent of Countries in the Sample which were Classified by the IMF as having:^a</i>			
	<i>Peg</i>	<i>Limited Flexibility</i>	<i>Managed</i>	<i>Flexible</i>
1970	97.2	0	0	2.8
1975	63.9	11.1	13.9	11.1
1980	38.9	5.6	47.2	8.3
1985	33.3	5.6	36.1	25.0
1990	19.4	13.9	30.6	36.1
1995	13.9	8.3	38.9	38.9
1999	11.1	11.1	33.3	44.5

Note:

^a Sample-based 154 exchange rate arrangements.

Source: Calvo and Reinhart (2000b).

attention has been focused on recent currency crises, these may point more to the weaknesses of pegging to one specific currency than about the weaknesses of pegging in general. This leads us to the specific case of Southeast Asia.

In principle, Thailand and the other regional countries were supposed to have adopted basket pegged regimes, with the US dollar, yen and other currencies receiving weights consistent with their respective significance in economic linkages with the Southeast Asian countries. However, in reality, the US dollar had the overwhelming weight *de facto* (Tables 3 and 4), leading McKinnon (1999 and 2000) and Ohno (1999) to refer to East Asia's 'dollar standard' and 'soft dollar zone', respectively. Significantly, the Japanese yen had a weight of less than 0.1 in the average Southeast Asian currency basket. This was despite the fact that Japan was the region's largest export market along with the US and the region's dominant import source (Table 5).² Japan was also the region's largest creditor, and a substantial share of bank lending (debt flow) and external debt (stock) to the region was denominated in yen (Tables 6 and 7). In other words, the Southeast Asian countries made the mistake of rigidly pegging to the US dollar rather than in pegging more flexibly to a basket of currencies.³

The remainder of this paper is organised as follows. The next two sections consider the limitations of the corner solutions of flexible and irrevocably or institutionally fixed regimes, respectively. These provide the background for the remainder of the paper (Section 3) which explores the case for currency baskets

² The dominance of Japan in external trade relations with Southeast Asia has coincided with large-scale inflows of Japanese foreign direct investment (FDI) into the region (i.e. FDI has been trade creating).

³ To be sure, Thailand and Malaysia had very rigid US dollar pegs, Indonesia pursued a crawling band arrangement (to compensate for inflation rate differentials between Indonesia and the US), while the Philippines was somewhere in between (Rajan, 1999; and Fischer, 2001).

TABLE 3
Currency Weights of Southeast Asian Countries, 1979–95

Currency	Frankel and Wei (1994) ^a		Kwan (1995) ^b	
	US Dollar	Japanese Yen	US Dollar	Japanese Yen
Indonesian rupiah	0.95	0.16	0.99	0.00
Malaysian ringgit	0.78	0.07	0.84	0.04
Philippine peso	1.07	-0.01	1.15	-0.24
Singapore dollar	0.75	0.13	0.64	0.11
Thai baht	0.91	0.05	0.82	0.11
Simple Average	0.89	0.08	0.88	0.00

Notes:

^a Based on weekly movements for the period January 1979 to May 1992.

^b Based on weekly movements for the period January 1991 to May 1995.

TABLE 4
Southeast Asian Exchange Rate Statistics, 1990–96

	Domestic Currency Per \$ Rate in 1990		Domestic Currency Per \$ Rate in 1996		Exchange Rate Variability (1990–96) ^a	
	End of Period	Period Average	End of Period	Period Average	End of Period	Period Average
	Indonesia	1901.0	1842.8	2383.0	2342.3	18.94
Malaysia	2.7105	2.7049	2.5290	2.5159	0.00	0.00
Philippines	28.000	24.311	26.288	26.216	0.13	0.13
Thailand	25.520	25.114	25.610	25.487	0.00	0.00

Note:

^a Coefficient of variation for the entire period 1990–96.

Source: Calculated by the author from IMF, *International Financial Statistics*, various years.

TABLE 5
Southeast Asian Exports and Imports, by Country and Region, 1996 (per cent share)

	Indonesia	Malaysia	Philippines	Thailand	Total
<i>Exports to:</i>					
US	16.0	18.2	34.1	18.0	19.2
Japan	27.8	13.4	18.0	16.8	18.3
Rest of Asia	25.4	46.8	25.9	36.8	36.8
<i>Imports from:</i>					
US	10.3	15.5	18.3	12.6	14.0
Japan	23.6	24.5	20.3	27.8	24.8
Rest of Asia	27.7	34.6	27.8	28.2	30.2
<i>Trade Balance:^a</i>					
US	5.4	7.9	29.3	4.1	10.1
Japan	-30.7	-29.4	16.2	-37.1	-20.4
Rest of Asia	-28.4	14.9	3.8	-0.0	4.2

Note:

^a Share of imports plus exports; - implies deficit.

Source: Calculated from IMF, *Direction of Trade Statistics*, various years.

TABLE 6
Nationality of Banks Providing Loans to Crisis-hit Southeast Asian Countries, 1997 (per cent share)

<i>To:</i>	<i>From: Japan</i>	<i>US</i>	<i>Europe</i>	<i>Others^a</i>
Indonesia	38	6	44	12
Malaysia	34	5	47	14
Philippines	13	17	60	10
Thailand	56	4	33	7

Note:

^a Mainly Asia (Hong Kong in particular).

Source: BIS, *Maturity, Sectoral and Nationality Distribution of International Bank Lending*, various years.

TABLE 7
Currency Composition of Long-term Debt to East Asia and the Pacific, 1997 (per cent share)

<i>Currency</i>	<i>Share</i>
Deutsche mark	1.8
French franc	1.1
Japanese yen	20.1
Pound sterling	0.5
US dollar	57.8
Multiple currency	13.1
All other currencies	3.1

Source: World Bank (1999).

as a general regime in its own right as opposed to being a compromise between the two corner solutions. Section 3 highlights the optimal weight of the yen in the regional currency baskets, as well as how such a basket might operate. The issue of whether there is a case for a common or joint regional currency basket is also discussed. The final section offers a summary and some concluding remarks.

2. WHY NOT FLOATING REGIMES?

While the advantages of a free float are well known (Frankel, 1999), countries with flexible regimes have experienced 'excessive' volatility over the last few decades.⁴ It is admittedly difficult to define what exactly is meant by the term 'excessive'. However, a reading of the literature on available empirical studies on

⁴ Of course, almost no country has maintained a completely free (or pure) float, the authorities intervening intermittently to smooth market fluctuations. In other words 'dirty floats' – i.e. forex market interventions without commitment to defend any specific parity – have been the norm. The US dollar probably comes closest to being a free float.

TABLE 8
Forex Market Activity (\$ Billions): Southeast Asia versus Industrialised Countries

<i>Country</i>	<i>GDP^a</i>	<i>Average Daily Turnover of Forex Activity^b</i>	<i>Relative Size^c (per cent)</i>
<i>East Asia</i>			
Indonesia	214.6	1.5	0.7
Malaysia	97.9	1.1	1.1
Thailand	153.9	3.0	2.0
<i>Advanced Countries</i>			
United States	8111.0	350.9	4.3
United Kingdom	1288.4	637.6	49.5
Germany	2102.6	94.3	4.5
Japan	4192.3	148.6	3.5
Switzerland	254.9	81.7	15.5

Notes:

^a Billions \$, 1997 data;

^b Billions \$, as of April 1998;

^c Average daily turnover to GDP ratio.

Source: Min and McDonald (1999).

exchange rates reveals that evidence of excessive exchange rate variability comes in a number of forms (Bird and Rajan, 2001a and 2001b; and Williamson, 1999a). For instance, a number of surveys of foreign exchange (forex) market participants clearly indicate that short-term/high-frequency exchange rate movements are caused by 'speculative' or 'trend-following' elements rather than underlying macroeconomic fundamentals. The problem of destabilising speculation (as opposed to the Friedmanite speculators) and consequent excessive exchange rate volatility appears to be exacerbated in developing countries, making a flexible regime especially unviable/unsuitable to them (Grenville and Gruen, 1999). This is particularly so since thin markets, which exist in Southeast Asia and other developing countries (Table 8), imply that a few transactions can lead to extreme exchange rate fluctuations.

Even if it were accepted that flexible exchange rates often appear to exhibit greater volatility in high frequency data than would be warranted by the underlying fundamentals, why might such excessive volatility be of concern? Recent studies have provided evidence of a negative impact of exchange rate volatility/uncertainty on investment (Corbo and Cox, 1995; and Huizinga, 1994).⁵ To the extent that investment has a significant positive impact on economic growth, declining investment will have an enduring adverse effect on the quantity of real resources. Even in the absence of a negative effect on the level of investment, exchange rate

⁵ Corbo and Cox (1995) and others also find that macroeconomic uncertainty in general has a deleterious impact on investment. Also see the broad literature survey by Serven (1997).

variability may have an adverse influence over the composition of investment since decisions could be based on disequilibrium prices.

It has often been argued that firms and other agents involved in international transactions can undertake hedging operations to shield themselves against exchange rate movements. However, apart from the costs involved with such operations, perfect hedges may be very difficult to create technically (given acute revenue-cost uncertainties) (Adler, 1994; and Friberg, 1996). Indeed, even if they could be created, they would entail non-negligible transaction costs, thus diverting scarce resources from 'real' economic activity. This is especially true in the case of developing countries where rudimentary capital markets have necessitated using cross-hedging techniques (rather than direct hedging), which invariably are far costlier.⁶ According to a 1992 survey of non-financial Fortune 500 corporations, while 85 per cent of the respondents hedged, only 22 per cent hedged *fully*. Not surprisingly, most of the respondents which did not hedge were smaller firms averaging US\$2 billion in capital (Felix and Sau, 1996; and Felix, 1996). It is important to keep in mind that such small and medium-sized enterprises dominate the economic landscape in developing countries.

Frankel and Wei (1994) have undertaken a cross-sectional study of bilateral trade. They find that bilateral exchange rate variability looks to have had a statistically and economically significant negative effect on trade between 1960 and 1985, though the impact – both economic and statistical – has been negligible between 1985 and 1990.⁷ Wei (1999) provides new empirical evidence suggesting that exchange rate volatility has had a detrimental effect on trade between pairs of countries to a much larger extent than suggested by previous studies. More generally, in a comprehensive survey of the literature on the impact of exchange rate volatility on trade flows, McKenzie (1999) concludes that the recent empirical studies have had 'greater success in deriving a statistically significant relationship between volatility and trade' (p. 100). Calvo and Reinhart (2000a) review a more limited set of such studies and draw a similar conclusion. Another recent set of empirics by Andrew Rose based on gravity models using both cross-sectional and time-series data suggests institutionally fixed exchange regimes (i.e. common currency, currency boards or dollarisation) stimulates trade, which in turn boosts income (see Frankel and Rose, 2001; Glick and Rose,

⁶ A referee makes the following point:

Rudimentary capital markets necessarily mean, for most emerging economies, a greater dependence on capital flows. That in turn may mean greater capital integration with neighbouring (developed) economies, a pattern which may conflict with OCA (optimum currency area) terms with the degree (and pattern) of trade integration. That in itself suggests some basket arrangement, rather than an overtight unilateral peg or floating.

⁷ On balance, these earlier time-series studies seem to have found an insignificant effect of exchange rate uncertainty on trade (see the synopsis of the literature by Willett, 1986).

2001; and Rose, 2000). As is common knowledge, such an argument was used extensively by proponents of the European Monetary Union (EMU).

Flexible exchange rates may also be associated with currency misalignments, with accompanying costs in terms of resource misallocation and detrimental effects on economic growth. Cooper (1999) nicely summarises the preceding discussion as follows:

The core problem is that for economies with imperfectly developed financial markets the exchange rate is the most important asset price, and it will be jerked around by changes in portfolio sentiments. But for an open economy the exchange rate is also the most important price in the market for goods and services. Jumping asset prices can badly disrupt the markets on which the economic well-being of the majority of residents depends. . . . (It is an open question whether a broad, diversified financial market based on the domestic currency can develop under floating exchange rates . . . The unwelcome conclusion that flows from this discussion is that free movements of capital and floating exchange rates are basically incompatible, except for large and diversified economies with well-developed and sophisticated financial markets (pp. 111–12).

Notwithstanding the recent weakness of the Australian dollar,⁸ its successful experience with a floating arrangement, particularly in terms of withstanding the East Asian crisis, has often been cited as evidence of the ‘superiority’ of such a regime, and has been prescribed as panacea for other developing Southeast Asian countries. However, such an advocacy does not pay due consideration to the fact that there are important structural differences between industrial countries such as Australia, on the one hand, and developing countries, on the other (Krugman, 1999). For instance, countries like Australia and the US have well-developed and diversified financial systems that are able to minimise real sector disruptions due to transitory exchange rate variations (abstracting from the resource allocation costs of misalignments noted above). Most importantly, industrial countries are able to borrow overseas in their domestic currencies. Many developing countries are unable to do so, leading to accumulation of foreign currency debt liabilities that are primarily dollar denominated and unhedged (i.e. ‘liability dollarisation’).⁹ In such countries, sharp depreciations in their currencies alter the domestic currency value of their external debt and therefore the net worth of the economies, with calamitous real sector effects (so-called ‘balance sheet’ effects).

⁸ The Australian dollar has lost half its US dollar value between the end of 1996 and early 2001. The *Economist* (29 April, 2000, p. 84) discusses reasons behind this.

⁹ This has come to be referred to as the ‘original sin’ hypothesis, a term attributed to Hausmann (1999) and Hausmann et al. (2000). It is unclear why many developing countries are unable to borrow long-term in their own currencies. McLean and Shreshta (2001) explore this issue using a case-study approach involving Australia, New Zealand and South Africa, all small and open economies that borrow internationally in domestic currencies. They conclude that countries where domestic long-term government debt is widely held by residents are more likely to convince non-residents to hold debt denominated in local currencies. They further suggest that the development of the Eurobond markets for debt denominated in Australian dollars, New Zealand dollars and the South African rand were instrumental in fortifying international access to domestic currency denominated debt.

This in turn may be an explanation for the ‘fear of floating’ by many developing countries discussed in Section 4 (Calvo and Reinhart, 2000a and 2000b; and Hausmann et al., 2000).¹⁰

3. WHY NOT IRREVOCABLY FIXED EXCHANGE REGIMES?

In view of all of this, many observers would concur with Williamson’s (1999c) conclusion about a floating regime:

(It) is not the option I would recommend, because of my doubts as to whether ... (such) a regime ... is consistent with the restoration of the sustained high rates of growth that were experienced by East Asia before the crisis (p. 1).

Consequently, there has been growing enthusiasm for the other corner solution of an irrevocably fixed regime. Such a hard peg, it is argued, signals greater commitment to rule out arbitrary exchange rate adjustments (i.e. ‘escape clauses’ cannot be invoked) and the authorities’ willingness to subordinate domestic policy objectives such as output and employment growth to the maintenance of the pegged exchange rate. The remainder of this section briefly touches on the potential problems of the three super fixes of a currency board arrangement, dollarisation and a regional monetary union as possible exchange rate policy options for Southeast Asia.

a. Currency Boards

The durability of the Hong Kong and Argentine currency boards in the face of acute speculative pressures in the 1990s appears to have convinced some observers of the virtues of such a regime for a number of developing countries, including those in Southeast Asia. In fact, the *Asian Monetary Monitor* (July–August, 1994, pp. 1–10) did suggest such a regime for the regional countries pre-crisis, and Indonesia toyed with the idea of this sort of arrangement during the early part of 1998.¹¹

Nevertheless, it is generally recognised that a currency board arrangement requires the satisfaction of a number of preconditions (Frankel, 1999), including a strong and durable domestic financial system that is able to withstand possible interest rate hikes on a sustained basis at times when the domestic currency is under selling pressure. Failing this, currency crisis vulnerability might merely be transformed to financial sector vulnerability (this point is formalised by Chang and

¹⁰ In fact, these effects were at least part of the reason why initial crisis-induced devaluations in these countries have been *contractionary* rather than *expansionary* (Hausmann et al., 2000; and Rajan, 2001a and 2001b).

¹¹ See Culp et al. (1999) in defence of the case for a currency board in Indonesia and Spiegel (1998) for the case against.

Velasco, 1998). To the extent that the banking systems in the regional countries have been decimated by the crisis, and the process of financial sector restructuring – while having progressed substantially – is far from complete, the currency board arrangement alternative appears to be infeasible over the near and medium terms.¹² This is particularly since the lender of last resort function of a central bank is eliminated by the introduction of a currency board, in turn implying the need for a strong, well-capitalised and well-supervised domestic financial system to be in place.¹³ There is also the question of whether the regional countries have the degree of labour market and internal flexibility – as in the case of Hong Kong, for instance – to make such a super fix viable. In addition, it is revealing that both Hong Kong and Argentina themselves have, in recent times, been enthusiastic proponents of exploring moves towards alternative hard peg arrangements by their respective regions – dollarisation in the case of Latin America; East Asian monetary *cooperation* or at least *coordination* in the case of Hong Kong. Cynics of currency board arrangements have interpreted this as the two economies looking for viable exit strategies from their respective currency board arrangements.

b. Dollarisation

In view of the limitations of the extremes of flexible and currency board arrangements, some observers have reached the conclusion that a single, regional currency zone may be the most attractive option for small and open economies. This entails an entire region adopting another country's currency (like the US

¹² For detailed descriptions of the financial restructuring programmes in the region, see Balino et al. (1999) and Rajan (2001b). An important component of financial restructuring involves the internationalisation of the financial sector, which is at least conceptually different from capital account deregulation (see Bird and Rajan, 2001b).

¹³ Of course, this loss of a domestic lender of last resort function may be partly compensated for through holding of excess reserves (over and above the domestic monetary base) as in the case of Hong Kong, or obtaining access to foreign credit line as in the case of Argentina. The point is sometimes made that the preconditions are not necessary for the implementation of a currency board or dollarisation (which overlap considerably). No doubt that dollarisation or currency board arrangements can be implemented prior to reforms; the key question is, what are the implications of doing so (Eichengreen, 2000)? It is useful to keep in mind that the failure to pay sufficient attention to the pre-conditions for successful financial liberalisation has been among the main reasons for financial crises in developing countries. Eichengreen (2000) provides a detailed review of the dollarisation literature and discusses the preconditions needed at some length. Pointing to the case of Argentina, he notes:

a long series of policy reforms (were) pursued for a decade, at the end of which dollarization serves to lock in fundamental reform by making it virtually impossible for the government to revert to its bad inflationary ways. . . . They cast doubts on assertions that those other reforms will necessarily follow from the decision to dollarize. They might, but if they don't the downside risks are considerable. Unlike the situation in countries like Argentina, where the groundwork for dollarisation has been laid and the outcome can be clearly foreseen, dollarisation by countries in the throes of the crisis is a high-stakes gamble (pp. 23–4).

dollar) as its own or establishing an entirely new one. Calvo and Reinhart (2001c) and Hausmann (1999) have argued that developing countries in Latin America should form a monetary union with the US, or more specifically, they ought to abandon their respective national currencies in favour of the US dollar (dollarisation).

While such a policy may have some merit in Latin America (though even here there are a number of sceptics such as Hale, 1999, and Willett, 2001), the relatively low levels of dollarisation in Southeast Asia (compared with Latin America), on the one hand, and the economically significant role played by Japan and the yen in Southeast and the larger East Asia, on the other, implies that dollarisation (let alone euroisation or yenisation) is not a serious option for this region.¹⁴ An important lesson from the East Asian crisis of 1997–98 is that if they had given greater weight to the yen when managing their currencies, there would have been lower degrees of regional real exchange rate overvaluations following the nearly 50 per cent nominal appreciation of the US dollar relative to the yen between June 1995 to April 1997 (which in turn led to a rise in the value of the regional currencies relative to the yen.¹⁵ For instance, in the case of Thailand, which was the ‘crisis trigger country’, various studies have suggested that the Thai baht’s pre-crisis real effective exchange rate (REER) was misaligned (‘overvalued’) by anywhere between 11 and 30 per cent relative to some measure of ‘equilibrium’ real exchange rate (Montiel, 1999; and Rajan, 2001a). Institutionalisation of the dollar pegs (via a currency board or dollarisation) would not have helped domestic economic performance to the extent that the problem was, at least partly, one of loss of competitiveness.

Consistent with this, a recent study of exports by about 100 developing countries to the US, Japan and Europe over the period 1983–92 concludes that the more flexible the exchange rate regimes the better the export performance (Nilsson and Nilsson, 2000). However, countries pegging to a composite group of currencies do not appear to have weaker performance than countries with independently floating regimes (data based on official IMF classification of exchange rate arrangements, i.e. *de jure* rather than *de facto* exchange rate regimes, is used).

In the final analysis, regardless of the economic arguments, very few countries appear willing to unilaterally abandon the domestic currency for that

¹⁴ The relative merits of dollarisation over a currency board are not discussed here (see Berg and Borensztein, 2000; Frankel, 1999; and Frankel et al., 2000). Suffice it to note here that the major advantage of dollarisation is a reduction in currency (and possibly even country) risk premium, therefore offering lower domestic interest rates, as well as elimination of concerns regarding the sustainability of the domestic currency peg (i.e. no escape clause). The major disadvantage of moving from a currency board arrangement to dollarisation is the loss of seigniorage, constraints on liquidity management, as well as the transition costs.

¹⁵ McKinnon (1999 and 2000) refers to the yen/US dollar exchange rate as the ‘loose cannon’ in East Asia pre-crisis.

of another country; national currencies are often seen as a sign of independence and self-determination. The political unpalatability of this policy, along with the above-noted policy constrictions of a currency board, therefore appears to leave only the third hard peg of a common regional currency as a practicable alternative. Is it?

c. Currency Union

Having experienced the turbulence of the regional crisis against the backdrop of the successful introduction of a single European currency, leaders of the Association of Southeast Asian Nations (ASEAN) agreed to study the feasibility of a common ASEAN currency system.¹⁶ There has been much popular discussion in the region about the economic and political possibility and desirability of forming a larger Asian Monetary Union (AMU) akin to the European Monetary Union (EMU).¹⁷ From an economic standpoint, Eichengreen and Bayoumi (1999a and 1999b) have concluded that East Asia may be as close to – or rather, as far away from – being an optimum currency area (OCA) as Western Europe.¹⁸ This conclusion is based on an OCA index that takes into account the costs associated with asymmetric region-wide shocks as well as the benefits from stabilising exchange rates with trading partners.¹⁹ More informally, but in similar vein, the IMF's Managing Director, Horst Kohler (2001), has noted:

trading patterns and geography do make it reasonable to think of the creation of an internal market in Asia as a possible, future stage in regional cooperation. And why should this not be a basis for greater monetary integration ... ? (p. 4)

There are at least two important differences between ASEAN/East Asia and Europe. First, any form of regional monetary union requires that there be compensating fiscal transfers from the richer to less well off states in the absence of sufficiently frictionless intra-regional labour mobility. In the case of Europe, the extent of such transfers is quite significant in per capita terms of the poorer states, but fairly low in absolute terms as the richer states in Europe are much larger than the poorer ones (Eichengreen and Bayoumi, 1999a and 1999b).²⁰ This

¹⁶ Announced as part of the latest ASEAN summit meeting in Hanoi and included in the 'Hanoi Plan of Action' (*Business Times*, Singapore, 15 December, 1998).

¹⁷ See for instance, the *Straits Times*, Singapore (11 January, 1999 and 4 October, 1998) and Curtis (1998).

¹⁸ Similarly, Rockoff (2000) has emphasised that the US could be said to have been an OCA only around the 1930s. See Kenen (2000) for a recent discussion of the OCA theory.

¹⁹ In any case, it is possible that OCA criteria may be at least partly endogenous, suggesting that some unions may be more justifiable *ex post* rather than *ex ante* (Frankel and Rose, 1998).

²⁰ A referee has cautioned that it is an open question as to how effective, important or appropriate these fiscal transfers have been to the poorer states in Europe. We do not pursue this issue here, only noting that the issue of division of fiscal transfers is a growing source of some tension in the Eurozone area with the expansion of the EMU to poorer Eastern European states.

is in contrast to ASEAN where the poorer regional members also happen to be the largest ones (Indonesia versus Singapore).

Second, the European experience has emphasised the need for strong political will and consensus towards such a policy goal. Indeed, some like Goodhart (1995) dispute the relevance of economic criteria altogether, claiming that political consideration dominate formation of currency areas. Such a political consensus, while possibly gradually emerging in Southeast and the larger East Asian regions, is still far off from being universal. To be sure, 'vision statements' by regional leaders for a currency union, while having become more common since the crisis, has hitherto not been backed up by any serious discussion on the type of institutional structures or formal mechanisms and decision-making bodies needed for such regional economic integration of monetary and exchange rate policies to be a success (such as an independent region-wide central bank, a system of inter-regional fiscal transfers, measures to ensure European-type macroeconomic convergence, and the like). Eichengreen and Bayoumi (1999b) have noted:

there is little sign, comparable to the evidence which has existed in Europe for nearly 50 years, of a willingness to subordinate national prerogatives to some larger regional entity. There is no wider web of interlocking arrangements, as in the EU, which would be put at risk by a failure to follow through on promises of monetary and financial cooperation (p. 11).²¹

Thus, Kenen's (2000) general conclusion that solving the problems of governance and accountability needed to form a currency union may be far too herculean a task for most other groups of countries outside Europe, appears especially pertinent to Southeast Asia and the larger East Asian region in the foreseeable future.

4. THE INTERMEDIATE RANGE RECONSIDERED

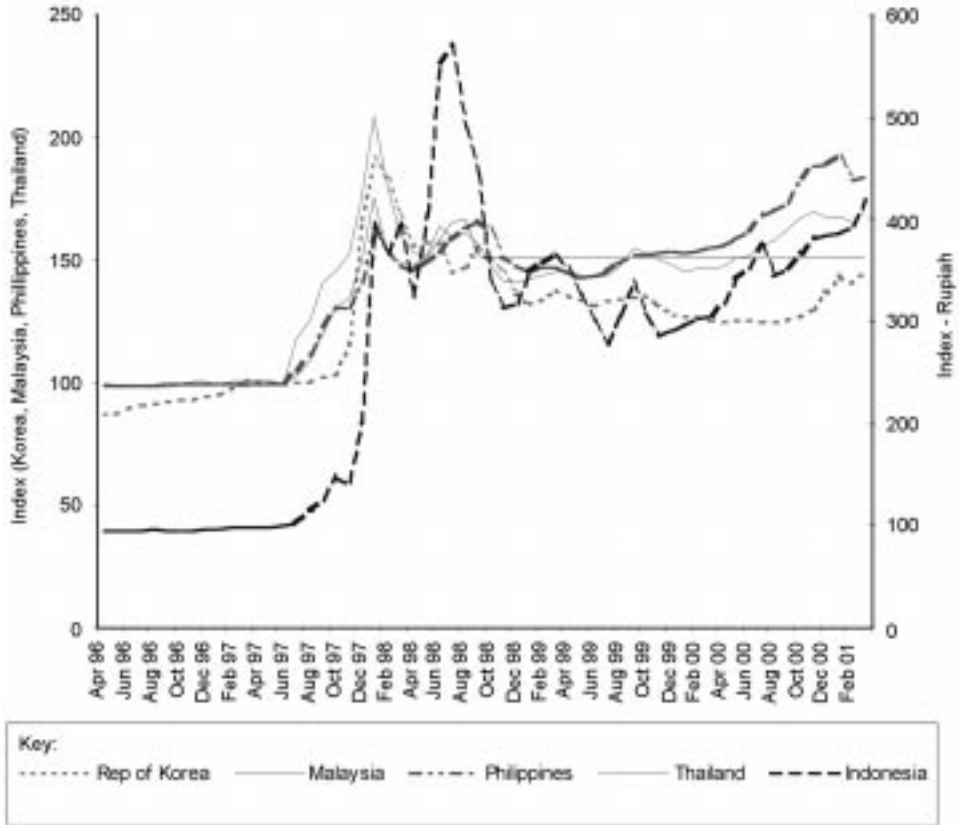
The preceding discussion suggests that the corner solutions may not be appropriate as practical short-to-medium term exchange rate options for the Southeast Asian countries. Actions always speak louder than words. Accordingly, it is revealing to observe the post-crisis *de facto* exchange rate policies of the regional crisis-hit Southeast Asian countries.

a. Revealed Preferences of Southeast Asian Central Banks

The Malaysian case is the most straightforward, the government having fixed the Malaysian ringitt (RM) relative to the US dollar on 1 September, 1998 (at RM

²¹ In addition, substantial asymmetries in the sizes and levels and stages of economic development of the countries in East Asia, on the one hand, and the *de facto* policy of strict non-intervention in one another's affairs (economic and particularly political), on the other, makes it extremely difficult to envisage the successful introduction of 'tie-in' clauses to create punishment mechanisms to ensure conformity of economic policies as done in Europe.

FIGURE 1
Bilateral Exchange Rates Relative to US Dollar (Jan-97 = 100), 1991–2001



3.80 per US\$) while simultaneously imposing capital account restraints. More interesting and complicated are the exchange rate choices of the other regional countries. It is commonly believed that Indonesia, Philippines and Thailand have maintained a float following their respective currency devaluations in mid and late 1998, see footnote 30). In actuality though, after a short flirtation with floating following the initial breakdown of currency pegs in mid-1997, the regional monetary authorities have appeared to have reverted to heavy management of their currencies to ensure some degree of stability *vis-à-vis* the US dollar. To be sure, there has certainly been a generalised move towards greater exchange rate flexibility during the post-crisis period (Figure 1). However, while the Malaysian capital controls have allowed for the simultaneous maintenance of monetary autonomy and a fixed regime (by breaking the ‘Impossibility Trilemma or Trilogly’), the other countries have depended on a combination of activist interest rate policy and forex market intervention to

ensure relative exchange rate stability.²² Consequently, they have experienced sharp gyrations in monetary variables and international reserves (Calvo and Reinhart, 2000a and 2000b; and McKinnon, 1999 and 2000). Some countries like Thailand have also taken steps to curb currency speculation (Mehta, 2001).

More evidence of this retreat away from free floating is seen by the rapid build up of foreign exchange reserves in the region since 1997 (Rajan, 2001b), and efforts by these countries to further buttress available resources through regional initiatives such as the recently agreed-upon swap arrangement among East Asian countries (Southeast Asian countries plus Japan, Korea and China). This agreement – dubbed the ‘Chiangmai Initiative’ – allows the countries to swap their own currencies for cash in a region-wide repurchase scheme (Chang and Rajan, 2001).

More generally, countries that proclaim themselves as having flexible exchange rates in fact have ‘soft pegs’ with monetary authorities actively managing their currencies. In other words, there is an acute and widespread ‘fear of floating’ among developing and even some developed countries. Floating in developing countries in general has been limited to short time spans immediately following a currency crisis (as in the case of Southeast Asia) or hyperinflationary episodes (Calvo and Reinhart, 2000a and 2000b). Thus, the official exchange rate classification by IMF (noted in Table 2), which suggests a sharp trend away from the intermediate arrangements (non-credible pegs) towards floating regimes in particular, is highly misleading.

b. The Case for Currency Basket Regimes

Consistent with the preceding discussion, the recent IMF report on exchange rate regimes has rightly cautioned that:

There is an important danger, however, in slipping back into *de facto* pegging of exchange rates against the US dollar. While this may be sustainable for some considerable period, this may well eventually contribute to recreating the problems that led up to the Asian crisis (Mussa et al., 2000, p. 59).

It is clear therefore that some sort of viable exchange rate regime – an intermediate solution – that is sustainable over the medium and longer term be prescribed for the Southeast Asian economies.

In a world of *generalised floating among major currencies*, the most feasible and desirable alternative for developing countries in Southeast Asia in the relatively near term may be a genuine currency basket arrangement.²³ By pursuing such an arrangement, the countries may be able to cushion its

²² For balanced and comprehensive discussions of the Malaysian capital controls see Athukorala (2000) and Kaplan and Rodrik (2001).

²³ Of course, if the major currencies (US dollar, Japanese yen and euro) are managed within certain target zones as sometimes suggested, there would be little difference between a single currency and multicurrency or basket currency arrangement.

TABLE 9
Comparing Optimal Weights of the Japanese Yen in Southeast Asian Currency Baskets

	<i>Indonesian Rupiah</i>	<i>Malaysian Ringgit</i>	<i>Philippine Peso</i>	<i>Thai Baht</i>
Bénassy-Quéré (1999)	0.30	0.21	0.23	0.29
Ito et al. (1998) ^a	0.56	n.a.	0.72	0.52
Eiji (1999)	0.45	0.40	0.40	0.40
Bird and Rajan (2000a) ^a	0.59	0.46	0.35	0.59
Kusukawa (1999) ^a	0.39	0.36	0.31	0.40
Kusukawa (1999) ^{a,b}	0.32	0.32	0.32	0.32
Williamson (1999b) ^b	0.33	0.33	0.33	0.33
Simple Average	0.42	0.35	0.38	0.41

Notes:

^a Based on the simple average of stated ranges.

^b Based on a common basket which includes the four Southeast Asian countries plus Singapore, South Korea, Singapore, P.R.C. China, Hong Kong and Taiwan.

Source: Compiled by the author.

vulnerability to fluctuations in the currencies of its major economic partners, thus limiting variations in the effective exchange rates.²⁴ In this light, it is revealing that Singapore, which was least impacted by the crisis (despite being the most open economy), was the only Southeast Asian economy to have pursued a genuine basket peg (Table 3) (the Singapore case is described briefly in the concluding section; also see Rajan and Siregar, 2000).

There have been a number of recent studies attempting to measure optimal currency baskets in Southeast Asia. As discussed previously, there is good reason to believe that the Japanese yen was significantly underweight in the baskets of the crisis-hit Southeast Asian countries. This is confirmed by Table 9, which summarises the estimates derived by the various studies of the yen's weight in optimal baskets for the regional currencies. To be sure, a simple average of the various studies reveals the optimal weight of the Japanese yen to be in the range of between 0.3 and 0.4, the remainder being divided between the US dollar, euro and/or regional currencies (depending on the type of study). This is far higher than the *de facto* pre-crisis weights of less than 0.1.

There undoubtedly remains much work to be done on refining the methodologies and assumptions used in the determination of optimal currency baskets (for instance, see Bird and Rajan, 2000a; and Williamson, 1999b). However, in the remainder of this section, we focus instead on the two other important policy issues, *viz.* the degree of fixity of the currency basket regime, and the possibility of a common or joint regional currency basket regime.

²⁴ Or, as a referee puts it 'a basket ... minimises volatility since variances ... are quadratic in the distance from the component bilateral rates.'

c. Rigid or Flexible?

A priori, there are at least four obvious reasons that underlie a preference for a greater degree of exchange rate flexibility (though not a flexible regime *per se* for reasons already highlighted). First, the greater the degree of flexibility of the exchange rate regime, the keener the incentives for agents to undertake appropriate forex risk management techniques in response to the higher element of exchange rate risk, while simultaneously reducing the extent of moral hazard which could lead to 'excessive' unhedged external borrowing (World Bank, 1999).²⁵ Second, the introduction of these transactions costs and exchange rate risks may also help moderate the extent of capital inflows, consequently dampening the intensity of boom and bust cycles. Third, small and open economies are much more susceptible to large external shocks, such as changes in foreign interest rates, terms of trade, regional contagion effects and the like. Received theory tells us that a greater degree of exchange rate flexibility is called for in the presence of foreign or domestic real shocks.²⁶ Fourth, many of the East Asian economies have diversified trade structures (dependent on the US, Japan, Europe and intra-Asian trade). OCA criteria suggest that such economies are good candidates to maintain more flexible regimes. Fifth, banks tend to dominate the financial systems in the region, and the credit transmission channel plays a significant role in these countries. Calvo (1999) has shown that, *ceteris paribus*, the operation of this credit channel (which affects the IS curve directly and acts as a real shock)²⁷ could tilt the balance in favour of greater exchange rate flexibility.

It is sometimes suggested that a rigid basket peg may operate as a nominal anchor for monetary policy and be a way of introducing some degree of financial discipline domestically and breaking inflationary inertia (Bird and Rajan, 2000a; and Edwards, 1993). Thus, a multicountry study of 136 countries over the period 1960–89 conducted by Ghosh et al. (1995) found inflation rates generally tend to be lower and more volatile under more flexible regimes (though economic growth is less volatile). An IMF (1997) study of developing countries in the mid-1990s reaches a broadly similar conclusion. However, apart from the previously noted problem of using official IMF statistics on exchange rate arrangements, the above conclusion is contested by Glick et al. (1999). They argue that policies of pegging exchange rates in East Asia were of little benefit in terms of acting as a counter-inflationary device, this goal having been attained primarily due to other factors such as relative autonomy of the monetary authorities. In their view, the use of exchange rates as

²⁵ Blinder (2000) refers to this as the 'fixed exchange rate bubble'.

²⁶ This conventional wisdom remains intact even with the introduction of liability dollarisation balance sheet effects (Céspedes et al., 2000).

²⁷ With the inclusion of the credit transmission channel in the textbook IS-LM framework, Bernanke and Blinder (1988) have renamed the IS curve the CC curve ('commodities and credit'). Spiegel (1995) considers an open economy extension of the Bernanke-Blinder framework (i.e. CC-LM-BP). Rajan and Sugema (1999) apply the framework to East Asia.

nominal anchors may have acted as a liability as it prevented the necessary adjustments in response to external shocks. In addition, both theory and lessons of experience with nominal anchors have shown that such pegging loses credibility over time and induces booms followed by inevitable busts and crises episodes.

d. Monitoring Bands

In view of the foregoing discussion, the suggestion by Dornbusch and Park (1999) and Williamson (1999a, 1999b and 1999c) for the maintenance of wide bands and, if need be, a crawl or slide to account for inflation differentials, seems to have strong rational, i.e. a so-called 'band-basket-crawl' or BBC rule. Such a system may be a way of trading off the disciplinary and credibility benefits of a pegged regime with the flexibility of a floating one. Admittedly, the distinction between a peg and a band is somewhat arbitrary. However, a peg is generally considered to be a band in which the maximum movements permissible on either side of the central parity are no more than 2.25 per cent (Frankel, 1999; and Mussa et al., 2000).

There remain other outstanding questions of significant importance. These include the appropriate size of the bandwidth (Williamson suggests a ± 5 to 10 per cent range); whether the bands should be 'soft margins' or 'soft buffers' such that the government may or may not intervene if the currency threatens to fall outside the pre-determined band (i.e. no absolute commitment); and whether the government should make explicit the values of the bands or this should be left more ambiguous as in the case of Singapore. The Monetary Authority of Singapore (MAS) describes its exchange rate policy as follows:

MAS manages the Singapore dollar against a basket of currencies of Singapore's main trading partners and competitors. The basket is composed of the currencies of those countries that are the main sources of imported inflation and competition in export markets ... The trade-weighted Singapore dollar is allowed to float within an undisclosed target band. The level and width of the band are reviewed periodically to ensure that they are consistent with economics fundamentals and market conditions. The MAS intervenes in the foreign exchange market from time to time to ensure that movements of the ... (Singapore dollar) exchange rate are orderly and consistent with the exchange rate policy.²⁸

The MAS seems to have adopted a 'monitoring band' as opposed to a 'crawling band' in which there is an obligation to defend the edges of the band. Williamson (1999a) discusses this point as some length:

The obligation ... (of a monitoring band) ... is instead to avoid intervening within the band (except in a tactical way, to prevent unwarranted volatility). There is a presumption that the authorities will normally intervene to discourage the rate straying far from the band, but they have a whole extra degree of flexibility in deciding the tactics that they will employ to achieve this. In particular, if they decide that market pressures are overwhelming, they can choose to allow the rate to take the strain even if this involves the rate going outside the band (p. 5).

²⁸ Obtained from the MAS website (www.mas.gov.sg).

To illustrate the degree of flexibility – critics would say, fuzziness – of the Singapore exchange rate policy, the MAS allowed the Singapore dollar to depreciate by about 20 per cent during the height of the East Asian crisis in mid-1997; while more recently, it is suspected to have intervened heavily in the market to prop up the Singapore dollar during recent bearishness against regional currencies following sharp falls in the NASDAQ in mid-2000 (*Straits Times*, 12 May, 2000).

Admittedly, this sort of monitoring band may be interpreted by some as being no different from a dirty floating regime. However, in contrast to a floating regime, with a monitoring band, the threat of possible intervention by the MAS may suffice to reduce speculative attacks. To quote Williamson (1999a) once again:

If the authorities choose not to defend the band, is that not floating? Actually, having a monitoring band may make a difference even if the authorities choose not to intervene, so long as the market knows that they can employ policy weapons which they might wield at some future date in seeking to push the rate back within the band, and they know where the band is. This knowledge should make the market fearful of pushing the rate so far as to set up the conditions for a bear squeeze (or a 'bull squeeze'). Another possible reason is that the market may believe that the authorities have chosen a correct estimate of the long-run equilibrium rate in their positioning of the band, and this again may discourage the market from pushing the rate as far as it would otherwise go (p. 5).²⁹

To be sure, there is no suggestion that such a band is a panacea against each and every speculative attack. Certainly it is not. As noted by the IMF report on exchange rate regimes:

(e)specially in the case of emerging market countries with substantial involvement on global capital markets, exchange rate bands are vulnerable to speculative attacks just as currency pegs are ... Bands typically function best as regimes of policy compromise when there is the readiness to adjust the central parity (or rate of crawl) in a timely manner in response to changing economic fundamentals (Mussa et al., 2000, p. 49).

Thus, the point of a monitoring band, or a crawling band with soft margins, is that it is a means of having some impact on the exchange rate without a specific exchange rate target which takes precedence over all other objectives.³⁰

²⁹ The argument for broader and more flexible bands is that they allow the authorities the time and space to demonstrate their commitment to the band boundaries with remedial measures before the boundaries are reached and speculators are offered a one-way bet (Hallett and Ma, 1995). I thank a referee for pointing this out. Williamson (1999a) makes a similar point in some detail.

³⁰ Of course, one could argue instead that developing countries should pursue fully flexible regimes with some sort of nominal anchor or monetary policy operating strategy, usually taken to be an inflation target (Eichengreen, 2001). In fact, in principle, Korea, Thailand and Indonesia, all of which have been under IMF-supported programmes, are supposed to have adopted more flexible exchange rate regimes in conjunction with inflation targeting. However, as Eichengreen (2001) has noted, none of them have put in place the other elements of inflation targeting and cannot be classified as genuine inflation targeters. In addition, given the high import content of consumption baskets in developing countries, targeting inflation (consumer prices) is, to some extent, akin to targeting the nominal exchange rate.

e. Common Currency Basket?

The preceding discussion seems to provide a strong case for a monitoring band, though bandwidth and rate of crawl would differ between countries based on individual circumstances and preferences. But what about the central parity? Should that be similar or different across the regional countries?

The IMF report on exchange rate regimes, which also recommends a currency basket regime for the regional economies, has noted that:

(i) it should be feasible to take some account of common factors that are likely to influence these economies in a similar if not identical fashion. In particular, movements in major currency (especially dollar/yen) exchange rates might be taken into account by shifting, on a regional basis, from exchange rate policies that focus heavily on the U.S. dollar to more of a currency basket approach (Mussa et al., 2000, p. 59).

This suggestion conceals significant ambiguity as to whether the IMF is in favour of a separate currency basket for individual countries in the region or a common region-wide basket. However, without getting into any details, the report then goes on to state that a 'joint peg to a basket of major currencies ... would arguably be a better choice than a single currency peg' (p. 62).³¹

The case for a common regional basket currency could possibly be made by the fact that, at least as far as the yen's weight is concerned, the computations of optimal pegs (based on a simple average of the studies) seem very close across countries in the region (Table 9).³² In addition, Drazen (1999) has developed a contagion model which is based on countries being in an implicit or explicit regional currency agreement. According to his model, a devaluation by any one country acts as a 'wake up call' to investors in the sense that it leads them to question the commitment of other regional countries to maintain 'club membership' by not devaluing, giving rise to a region-wide contagious crisis. This, along with the possibility of a competitive devaluation if each individual economy pursued its own individual currency basket, may be an additional reason for favouring a currency basket. As noted by Williamson (1999b), such a joint basket would:

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 (p. 342).

However, as noted previously, each individual country must in turn distinctly decide the size of the band and the extent of flexibility depending on country

³¹ Other proponents of a common currency basket include Dornbusch and Park (1999), Kusakawa (1999), Ohno (1999) and Williamson (1999b and 1999c).

³² It is important to stress that this conclusion is based on a simple average of the various studies. If one considered individual studies such as Bird and Rajan (2000a) and Ito et al. (1998), one finds that there is a significant difference between the weights computed for the Philippine peso, on the one hand, and the Thai baht and Indonesia rupiah, on the other.

circumstances, particularly since the speeds of recovery from the crisis and degrees of vulnerability to various shocks are quite varied (Mussa et al., 2000).

Such a currency basket may also justify an expansion of the previously noted Chiangmai (swap) initiative by East Asian central banks to include – at least partial – pooling of reserves to create a regional credit facility and make transparent the hitherto implicit exchange rate policy coordination through unilateral perusal of *de facto* US dollar pegs.³³ Alternatively, if such a region-wide basket regime is not politically tenable, each of the countries may want to initially formulate distinct currency baskets and gradually work towards a more uniform or common regional currency basket, though the financial market implications of the dynamics involved – including whether this should be a stated and transparent policy – remain unclear.³⁴

5. CONCLUDING REMARKS

The crisis in Southeast Asia has emphasised, among other things, the dangers of developing countries pegging their currencies to the US dollar (or any single currency for that matter). In response to this and other recent currency crises, the current mainstream thinking on the issue appears to be that developing countries should eschew intermediate exchange rate arrangements in favour of the corner solutions of either credible fixity or flexible rates. However, this prevailing sentiment in favour of the bipolar or binary view of exchange rates is not without its doubters. For instance, Bergsten et al. (1999) has made the important point that:

(m)anaged floats do not have the clean, clear-cut allure of full institutional purity, but, in a world of second-bests, they are worth exploring (p. 9).

Indeed, Stanley Fischer (2001) has acknowledged that there are many instances where intermediate regimes might well be ‘more appropriate’ than corner solutions.³⁵ Frankel (1999) has provided us with two timely reminders: (i) the

³³ Kusakawa (1999) recommends the establishment of a regional body to support the common basket system, possibly some kind of Asian Monetary Fund (AMF). See Bird and Rajan (2000b) and Chang and Rajan (2001) for detailed discussions of the AMF. The importance of accumulating reserves that cover the existing stock of short-term debt has been emphasised as being a key element of ‘self-protection’ from currency crises (Feldstein, 1999). Contingent credit facilities from foreign banks, including the internationalisation of domestic banking systems, may be seen in the same light, and may in fact be a superior form of self-protection. Chilean-type controls are also being increasingly viewed as an important element of this sort of self-protection (Bird and Rajan, 2001b; and Fischer, 2001).

³⁴ As a referee has pointed out, a danger with regional baskets is that by collectively fixing within a bloc, the bloc may become more unstable *vis-à-vis* the rest of the world.

³⁵ In fact, Fischer (2001) has noted that the bipolar view of exchange rates ought to be presented as a choice between a hard peg versus a ‘more flexible regime’ rather than a flexible exchange rate regime *per se*. The latter option implies the absence of any explicit exchange rate target, i.e.

'Impossible Trinity or Trilogy' does not on its own imply that in an increasingly globalised world economy an intermediate regime is unviable; (ii) few developing countries appear to meet the OCA criteria to make either corner solution an ideal choice and 'one size does not fit all' (also see Kenen, 2000; and Willett, 2001).

A great deal has been made of Hong Kong's ability to maintain its US dollar-based currency board arrangement in the midst of acute bearish pressure in 1997–98. Much less recognised is the fact that Singapore, which pursued a monitoring band arrangement pre-crisis, and continues to do so post-crisis, weathered the East Asian crisis comparatively well despite having extremely strong direct trade and financial linkages with most of the crisis-hit regional economies (Rajan and Siregar, 2000).³⁶ Revealingly, Singapore was the only one of the Southeast Asian economies to have maintained a genuine currency basket regime pre-crisis (a monitoring band).

A recent argument put forward against a 'complicated' intermediate regime such as currency baskets with monitoring bands is that they are less 'transparent' or 'verifiable' by financial market participants than their 'simple' and 'straightforward' counterparts on either extreme (Frankel et al., 2000). While it is true that the corner regimes can be more easily monitored, arguably of more importance to financial markets participants is the notion of 'credibility' rather than 'transparency'.³⁷ Most informed observers would agree that the Monetary Authority of Singapore (MAS) has developed and inspired a great deal of credibility over the years in the management of the country's currency despite a lack of transparency in the actual specifics of the currency basket regime.³⁸

In this spirit, we have argued in the case of Southeast Asia that while the soft US dollar pegs operated pre-crisis were sub-optimal, a more flexible peg

intervention should not be framed primarily in terms of defending a particular exchange rate target. This is completely consistent with the position taken in this paper for reasons discussed above.

³⁶ While Hong Kong's overall GDP declined by 5 per cent in 1998, Singapore's growth stagnated in 1998 (0.4 per cent), a sharp contrast to the annual average growth of 9 per cent in the first half of the 1990s. The primary reason for this difference in growth was that the nominal exchange rate flexibility in Singapore was able to cushion some of the negative shock, unlike Hong Kong where adjustments in the real exchange rate had to be fully realised via domestic deflation (Rajan and Siregar, 2000).

³⁷ Frankel et al. (2000) incorrectly assume that greater verifiability automatically implies greater credibility. This point is stressed by Blinder (2000) and Velasco (2000).

³⁸ Drawing on the trade and industrial policy literature, one possible argument against a currency basket is that 'government failure' could exceed 'market failure'. If this is so, it suggests the need to minimise policy discretion, thereby supporting the move to one of the corner regimes. Given the problems with a pure float (any kind of dirty float would be faced with the problem attributable to government failure), this automatically implies the institutionalisation of exchange rates. As discussed previously, the only economically viable hard peg for East Asia appears to be a common currency; but this is politically infeasible currently. Another dilemma worth noting is that Singapore, which has successfully managed its currency basket regime, has the least incentive in the near term to support a common regional currency.

against a diversified composite basket of currencies would have enabled the regional countries to better deal with the third currency phenomenon which may have contributed to the crisis. In other words, the problems in Southeast Asia have more to do with the *nature of the peg* (i.e. rigid, US dollar based) rather than with the *policy of pegging* itself. More controversially, but in recognition of the close interlinkages and mutual real and monetary interdependencies that exist between countries in Southeast Asia (and possibly the larger East Asia), a case might even be made for a common regional basket, with the yen and US dollar each constituting around one-third to two-fifths of the regional currency basket (the euro and other currencies making up the remainder). However, the currency basket arrangements should involve a 'fairly high' element of flexibility rather than a single-minded defence of a particular rate. This may be best achieved by a variant on sliding parities and wider bands, the extent of which varying across the countries depending on individual circumstances and policy preferences.

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