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The Dilemma of Exchange Rate Arrangements in
East Asia (Ogawa and Yang, 2006)

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1. INTRODUCTION

In 1997 East Asian (EA) countries experienced a currency crisis which broadened to a banking, financial and general economic crisis. Starting from Thailand, the depreciation of The Baht led to contagious attacks on other currencies, with huge devaluations, a high rate of interest and mass bankruptcies in domestic financial institutions and business enterprises. (McKinnon, 2005) It is believed that the currency regime was not the major factor of the crises, but the collapse of The Bath was the trigger factor in the East Asian crises.

Following the East Asian financial crises, the issue of exchange rate arrangements and financial cooperation has become prominent for economic scholars. Increased cooperation among East Asian economies is an important response to preventing future currency crises and to strengthen financial systems within the region. Ogawa and Yang (2006) have examined the flexibility of exchange rates in East Asia and observed the transformation of exchange rate arrangements in the Post crises in their paper "The Dilemma of exchange rate arrangements in East Asia". Generally speaking, they argue that the various models of exchange rates in East Asia can threaten integration of East Asian economies as a whole because as a result of pressure on competitive intervention, a "*beggar thy neighbor*" situation is likely to arise. Consequently, this would increase economic instability and slow down regional trade arrangements and economic integration in East Asia.

This situation has brought the idea of regional cooperation in the form of the proposal to use a Currency Basket Regime (CBR) to stabilize intra-regional exchange rates. Although the idea of implementing CBR seems viable and would speed up an economic integration within regions, Ogawa and Yang (2006) lack valid data and convincing analysis to support their argument that it is necessary for East Asian economies to develop such an exchange rate system.

The main objective of this paper is to critically review the Eiji Ogawa and Doo Yong Yang paper "The Dilemma of exchange rate arrangements in East Asia", by addressing 3 major concerns mentioned in that paper : 1) Asymmetric responses to external shocks, 2) Competitive devaluation and 3) The dilemma of asset and liability Dollarization. Furthermore, this paper will also put forward arguments against the

external Currency Basket Regime (CBR) and discuss the feasibility of external Currency Basket Regime (CBR) for East Asia.

Following on from this introduction, the remainder of this paper is structured as follows. Section two considers the stylist facts of exchange rate movement during, before and after crises. These discussions examine the distortion between the De Jure and De Facto exchange rate regime to explain the current situation in East Asia. Section three examines 3 major concerns pointed out by the authors: 1) Asymmetric responses to external shocks, 2) Competitive devaluation and 3) Dilemma of asset and liability Dollarization. Section four examines the policy implication and asks whether the CBR regime is viable for East Asia economies. Section five is the conclusion.

1. SNAP-SHOT OF EXCHANGE RATE REGIME IN EAST ASIA : DE JURE VS DE FACTO

This section outlines recent exchange rates regimes in East Asia and assesses the discrepancy between De Jure and De Facto features of the exchange rate regimes in East Asia as pointed out by the Ogawa and Yang (2006).

Ogawa and Yang (2006) (in section 2.3) outline a critical point regarding the gap between De Jure and De Facto functioning rate regimes. They asses the discrepancy between De Jure and De Facto exchange rate arrangements by using 4 methods, such as : Levy-Yeyati and Sturzeneger (1999), Reinhart and Rogoff (2002), Flexibility Index (Bayoumi and Eichengreen, 1998) and official announcements from the IMF. With respect to the latter, Ogawa and Yang (2006 pp.10) conclude:

“... The IMF classification did not reflect the true exchange rate regime of a specific country, as exchange rate regimes often differed from what the authorities officially declared them to be.”

Table 2.1 The exchange rate regimes based on difference sources

Ogawa and Yang (2006)			IMF (2005)		
China		2003	China	Conventional peg arrangement	
	IMF	3			
	Levy				
	RR				
	FI	0			
Hongkong			Hongkong	Currency Board	
	IMF	2			
	Levy				
	RR				
	FI	0			
Indonesia			Indonesia	Managed floating with no predetermined path	
	IMF	7			
	Levy				
	RR				
	FI	0.183			
Japan			Japan	Independently floating	
	IMF	8			
	Levy				
	RR				
	FI	0.339			
Korea			Korea	Independently floating	
	IMF	8			
	Levy				
	RR				
	FI	0.100			
Malaysia			Malaysia	Conventional peg arrangement	
	IMF	3			
	Levy				
	RR				
	FI	0			
Philippines			Philippines	Independently floating	
	IMF	8			
	Levy				
	RR				
	FI	0.187			
Singapore			Singapore	Managed floating with no predetermined path	
	IMF	7			
	Levy				
	RR				
	FI	0.086			
Thailand			Thailand	Managed floating with no predetermined path	
	IMF	7			
	Levy				
	RR				
	FI	0.272			

Resource: Ogawa and Yang (2006) and Rajan (2006) (Modified)
 Note: **IMF classification:** exchange arrangement with no separate legal tender,1; currency board arrangement, 2; conventional pegged arrangement,3; pegged exchange rate within horizontal bands,4; crawling peg,5; crawling band,6; managed floating with no pre-announced path,7; independently floating,8.
Levy: NA means that classification variable is not available. Fix+, inconclusive; Fix*, uncontroversial; Interm, dirty; Interm*, dirty/crawling peg; 2, classified in 2nd round; 3, outliers.
Reinhart and Rogoff (find grid): no separate legal tender, 1; pre-announced peg or currency board arrangement, 2; pre-announced horizontal band that is narrower than or equal to -/+2 percent, 3; De Facto peg, 4; preannounced crawling peg, 5; pre-announced crawling band that is narrower than or equal to -/+2 percent, 6; De Facto crawling peg, 7; De Facto crawling peg that is narrower than or equal to -/+2 percent, 6; De Facto crawling peg, 8; preannounced crawling band that is wide than or equal to -/+2 percent, 9; De Facto crawling peg that is narrower than or equal to -/+5 percent, 10; moving band that is narrower than or equal to -/+2 percent, 11; managed floating, 12; free floating, 13; freely falling, 14.

Based on official announcements from each central bank of Asian economies, a number of East Asian economies which appear to adopt a *fixed exchange rate* regime or form of *single currency pegs* are Hong Kong (Currency Board Regime or Peg to US Dollar), and Brunei (Peg to Singapore Dollar). On the contrary, Indonesia, The Philippines, South Korea and Thailand have announced *flexible exchange rate* regimes accompanied by an *Inflation Targeting* framework. In addition, the other East Asian economies, such as : Malaysia, China, Japan, and Singapore have implemented a variety of intermediate regimes (e.g Currency Basket, Crawling Bands and Adjustable Pegs)

Thailand and Indonesia have been classified as *managed floating* by IMF but their official announcements were *independent floating*. China has announced it will adopt a *“basket regime”* despite appearing to be a soft peg to the US Dollar. Furthermore, Malaysia which officially announced to adopt *“single currency peg”* (peg to the US dollar) is seems faced a greater fluctuation vis-à-vis the US Dollar). Overall therefore, these two examples show that *“One size does not necessarily fit all”* when it comes to the choice of exchange rate regimes in Asia. (Rajan, 2006)

Another interesting point in this section is related to the behavior of exchange rate after the crisis. As pointed out by Ogawa and Yang (2006 pp.10) *“...Most of them actually have a substantially less flexible exchange rate than is officially announced, due to a fear of floating.” pp. 10*. It can be seen that in the past few years, some countries have accumulated a huge amount of reserve to defend their currency from excessive volatility. It seems that some East Asian countries are behaving more prudently by building up more reserve. The questions now are why they have a *“fear of floating”*?

Generally speaking, *“fear of floating”* is the situation in which the fluctuation of domestic exchange rate is very small due to the intervention of central bank to make the value of exchange rate constant to other currency value. As pointed out by Kaminsky and Reinhart (2001), some emerging economies have a *“fear of floating”* because if they have a pervasive dollar liability, devaluation could be associated with recession and inflation. On the other hand, the countries that have good circumstances (good TOT-Term of Trade, net inflow of capital etc) seem reluctant to appreciate their currency

because they do not want to lose their international competitiveness and it also can lead to deflationary spiral as the exchange rate appreciate.

In recent years, there is mounting evidence that some East Asian Economies tended to return to peg to US Dollar after the crises. McKinnon, R. I. and Schnabl, G. (2004) have pointed out that before the crises East Asian economies were trapped by *“Original Sin”*, but after they change from net creditor to be net debtor, they face *“conflicted virtue”*.

As pointed out by Eichengreen and Hausmann (1999), the term of *“original sin”* can be defined as a situation in which the domestic currency cannot be used to borrow abroad (international original sin) or to borrow long term, even domestically (domestic original sin). On the other hand, the term *“conflicted virtue”* is the mirror of the *“original sin”* concept, which happens in the international creditor country that cannot lend in its own currency. (McKinnon, 2004)

Eichengreen et al. (2003a) pointed out that original sin is common in most emerging markets which are normally international net debtors. Even for countries with a sustained record of stable domestic prices, they face difficulties borrowing internationally in the domestic currency. Also, due to the incompleteness of financial markets, government think that they have to undertake high-frequency exchange rate pegging in order to mitigate payment risk. In the presence of financial market incompleteness, financial fragility is likely to appear because domestic investment will have either a *“currency mismatch”* or a *“maturity mismatch”*.

Table 2.2 Standard deviations of Monthly exchange rate fluctuations against the US Dollar

	Pre-Crisis (94-97)	Crisis (97-98)	Post-Crisis (99-03)
Chinese Yuan	0.25	0.03	0.00
Hong Kong Dollar	0.08	0.07	0.04
Indonesian Rupiah	0.26	26.54	5.28
Malaysian Ringgit	1.06	6.69	1.96
Philippine Peso	1.19	5.25	1.71
Singapore Dollar	0.76	2.88	1.20
Thai Baht	0.43	8.88	1.62
Japanese Yen	3.66	3.64	2.43

Source : Mc Kinon, 2004 (Modified)

The table above reveals the standard deviation figure of East Asian (EA) exchange rates against US Dollar in three different times; pre crises, crises and post crises. Generally speaking, almost all the EA countries have pegged their currencies to

the US Dollar in a high rate in the pre crises period. However, in a time of crises they fluctuated more freely. After the crises, they tend to return to pegging their currencies to US Dollar but in a lower frequency. This evidence strongly reveals how the EA economies have returned to stabilize their currencies against the U.S Dollar after the crises.

As pointed out by Mc Kinon (2004), the “*original sin*” situation has transformed to be a “*conflicted virtue*” after the crises. A huge surplus due to current account surplus and net inflows of Foreign Domestic Investment (FDI) has made emerging economies net creditors. However, due to the incompleteness of financial markets these economies are unable to lend their own currency to international markets. This condition is labeled by Mc Kinon as the “*conflicted virtue*” syndrome. All in all, they have fear of allowing their currencies to appreciate because it can lead to deflationary spiral and dampen their exports. Consequently, East Asian governments have returned to maintaining a “soft dollar peg” to US\$. The table below shows that the amount of FOREX reserve in EA economies has increased significantly after the crises. In 2004, for example, the amount of Japanese and Chinese FOREX reserve had reached 21% and 15% of world total respectively. Furthermore, the other Asian economies had accumulated for about 17% of world total in the same year.

Table 2.3 Foreign Exchange Reserves in Asia, 2000 to 2004

	2000	2002	2004	Change, 2002-2004
Billion of Dollars				
Japan	347	451	824	373
China	166	286	610	324
Hong Kong	108	112	124	12
Taiwan	107	162	242	80
South Korea	96	121	198	77
Other	340	449	663	215
Total	1,163	1,581	2,661	1,080
Percentage of World Total				
Japan	17	18	21	26
China	8	11	15	23
Hong Kong	5	4	3	1
Taiwan	5	6	6	6
South Korea	5	5	5	5
Other	17	17	17	15
Total	57	62	67	77
Memorandum:				
World total (billions of dollars)	2,048	2,569	3,978	1,409
Source: IMF and the Government of Taiwan				

2. CONSEQUENCES OF DIVERSIFIED EXCHANGE RATES REGIMES IN EAST ASIA

Ogawa and Yang (2006) propose the idea of an external Currency Basket Regime (CBR) by explaining that such regional exchange rate coordination could help to prevent competitive devaluation and to solve coordination failure among countries in the region. Coordination in exchange rate arrangements as Ogawa and Yang (2006) point out can be avoid the detrimental effect of contagion in the event of another currency crisis. Contagion occurred during the crises when the devaluation of The Baht quickly triggered financial turmoil in East Asia. Actually, they argue that the various models of exchange rates in East Asia can threaten integration in East Asian economies as a whole as a result of pressure on competitive intervention, a “*beggar thy neighbor*” situation is likely to arise. Consequently, economic instability would increase and slow down regional trade arrangements and economic integration in East Asia.

The basic idea behind the parallel currency regime or Basket Currency Regime is this regime is one of the steps towards the alternative regional monetary integration and economic integration. In line with those arguments, Eichengreen (2006) pointed out that adopting a multilateral currency grid has the important objective of maintaining stability of exchange rates in the region. Thus, it would promote intra regional trade, simplify investment planning and encourage cross border participation in local bond markets. However, he stressed the risk of such an arrangement in the presence of high capital mobility. In short, he suggested the importance of closer integration in political commitment and the maintenance of credibility are the key to success.

More issues about the feasibility of Basket Currency Regime (intermediate exchange rate regime) will be examined in the next section.

In the examination of the Ogawa and Yang (2006) arguments, there will be a focus on 3 concerns, 1) Asymmetric responses to external shocks, 2) Competitive devaluation and 3) Dilemma between asset dollarization and liability dollarization.

In the first case, Ogawa and Yang (2006) pointed out that the *asymmetric response* of the EA currencies to the fluctuation of US dollar could bias the relative price of EA products, and consequently cause misallocation in terms of international trade

and FDI (Foreign Direct Investment). In line with this argument, they argued that the East Asian central banks face a “*coordination failure*” problem in choosing an optimal or desirable exchange rate system. Based on this situation, they suggest the introduction of the regional coordination for a desirable exchange rate regime (i.e. Basket Currency Regime) instead of the existing diversified exchange rate regimes.

Firstly, I will argue that the asymmetric reaction of EA exchange rates to US Dollar depreciation should be recognized as a natural movement of the exchange rate fluctuation. Each country is different in respect to their macroeconomic and trade structures. For example, the correlation of US monetary policy and its impact on Indonesia must be different to Singapore because Singapore has a stronger linkage in trade with US than Indonesia. Consequently, the depreciation of US\$ will have a different impact on the Rupiah versus the Singapore Dollar.

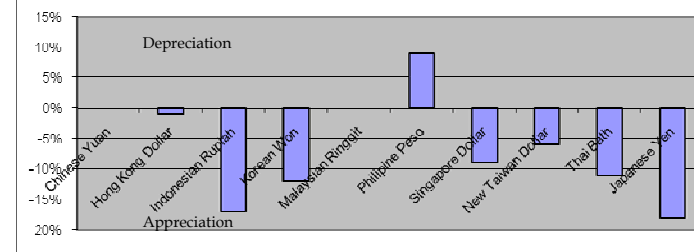
The different policy strategy in FOREX intervention and monetary policy can also contribute to the differential impact of US\$ fluctuation to EA exchange rates. Moreover, as suggested by Glick (2002), because the East Asian economies remained subject to different domestic and external shocks, market pressures on their exchange rates are likely to be different over time.

Secondly, the asymmetric reaction of EA exchange rates to US Dollar depreciation should be considered carefully by the model. Giavazzi et.al (1986) have observed the asymmetric reaction to US dollar depreciation in European countries in 1973-1985. Based on their research, there were 2 important models to explain the exchange rate movement. The first is based on a dynamic model of portfolio choice. The second uses a modified portfolio model which allows for the presence of capital controls. They found that the (sterilized) foreign exchange market operations which affect the relative asset denominated in different currencies should have a larger effect on the price of assets in economies with capital controls, and hence on their exchange rate. Furthermore, this result also depends on market thinness, which is associated with lump-sum transaction cost.

Thirdly, as observed by Mc.Kinnon, almost all EA economies had similar reactions to the US depreciation. It can be seen from the figure 3.1 below that since US dollar started to depreciate in 2002, EA exchange rates tend to appreciate considerably

against the dollar except The Peso and The Chinese Yuan. However, each East Asian central bank intervened heavily to buy dollars, to prevent their currencies from appreciating. As shown in table 2.3, the amount of official foreign reserves in East Asian countries has increased significantly after the crises. (McKinnon and Schnabl, 2004 pp.179-180)

Figure 3.1 Exchange Rate Changes against the US Dollar, 2002:01–2004:04 (Percentage)



Source: McKinnon and Schnabl, 2004 (modified)

All in all, there will be a serious problem when a country condition needs to realign its currency due to external shock, but it is constrained by the “club” or regional common arrangement. The consequence must be painful to a domestic economy when price level and labor market flexibility is absent. This is because with a fixed nominal exchange rate, the adjustment in the real exchange rate will have to take place through changes in domestic nominal prices and domestic wages. But, if the price and labor flexibility is absent, the output loss will become bigger. In other words, there must be a cost of adjustment if the country moves to new common currency arrangement. Furthermore, this situation can also be tested by speculators if they lack the credibility to maintain new CBR regime.

This evidence highlights the weaknesses of the Ogawa and Yang (2006) arguments about the asymmetric response problem in EA countries. They also provided no evidence of the cost of adjustment when EA economies join to new regional exchange rate regime.

Of additional concern, Ogawa and Yang (2006) have pointed out the “competitive devaluation” problem in EA regions. By exploring this concern, Ogawa and Yang (2006) use a correlation between the degree of Japanese intervention and other selected EA countries. They argued that if the intervention of the Japanese authority (BOJ-Bank of Japan) influences the Yen/Dollar exchange rate, this movement could be a pressure for “competitive devaluation” by other EA countries. Based on table 11, most countries in EA have a positive correlation with BOJ intervention, except China. However, the degree of correlation is different in each case. Hong Kong and Taiwan have strong correlation with Japanese intervention, with 0.850 and 0.830 respectively. The other countries correlation ranged between 0.007 – 0.723.

Table 3.1. Intervention correlation between Japan and Other selected countries

Countries	2005
China	- 0.246
Hong Kong	0.850
Indonesia	0.007
Korea	0.440
Malaysia	0.207
Philippines	0.723
Singapore	0.159
Thailand	0.553
Taiwan	0.830

Resource : Ogawa and Yang, 2006

Before discussing the case of “competitive devaluation”, it is important to observe the correlation between Japanese intervention and their periphery-East Asian neighbors. As observed by Spencer and Wong (2002) who conducted research into the impact of Japanese Yen on its periphery (East Asia) conclude that the movements in the Japanese yen/US\$ exchange rate have only a small impact on the EA economies. In their research, they used an elasticity method to measure a series of real effective-exchange-rates in East Asia. Based on their finding, the result of simple trade weighted index between China and Japan is 0.22, while the weights based on their bilateral competition and estimated elasticity is no greater than 0.10. Furthermore, the corresponding weight for an index focused on competition in third-country markets is 0.15. This evidence suggested that the Japanese Yen/US \$ exchange rate have small impact to its periphery-East Asia economies.

Furthermore, as pointed out by Bernanke (2000) (cited in Mc Kinon, 2003 pp.1068)

“...beggar thy neighbour argument against competitive devaluation had its origins in the Great Depression and does not apply to contemporary Japan and East Asia.”

Based on these facts, the case of competitive devaluation as suggested by Ogawa and Yang (2006) in EA economies is weak. This is because the Japanese Yen/US \$ does not have a strong effect on EA economies. It could be argued that the “Yen Carry Trade” (YCT) problems should be pointed out as the important factor in the 1997 crises. However, in recent days this YCT transaction has declined significantly.

In a general sense, the concept of “competitive devaluation” is a problem (as pointed out by Gerlach and Smets (1996)) when a currency crisis in one country may lead to devaluation in a second country if the two countries are connect in strong bilateral trade. In a similar vein, Corsetti, Pesenti, and Roubini (1999), stress that competitive devaluation pressures may arise even if two countries do not directly trade with one another. Such pressures may be present if the two countries are competing in a common third market.

Kaminsky and Reinhart (1999) have also investigated the possibility of trade and financial linkages among the Asian economies which may help explain why devaluation in small country like Thailand could significantly affect regional crises. However, they found that the trade and financial linkages are not the only the vital factors causing the contagion of currency crises. They found evidence that common bank lenders have played a significant role in the spread of currency crises. Specifically they found that the bank lending channel surpasses trade channels in explaining the vulnerability of a country to contagion.

The concept of “competitive devaluation” should also be recognized as the important channel of contagion which can lead to a regional currency crises. The example of “competitive devaluation” can be captured in the 1997 crises when the depreciation of Baht has spread widely to other currencies in regions such as Philippines, Indonesia, Malaysia and South Korea, which at that time, had a tremendous decline in the value of their currencies. Generally, there are two important explanations of contagion. The first point is “fundamental based contagion”. In this type, fundamental causes of contagion include macroeconomic shocks that have consequences on an international scale. Those shocks are transmitted through trade links, competitive

devaluations, and financial links. In other words, this interdependence means that shocks can be transmitted across countries because of their real and financial linkages. The second point is “*role of speculators*”. In this case, contagion involves a financial crisis that is not linked to observed changes in macroeconomic or other fundamentals but is solely the result of the behavior of investors or other financial agents. Under this definition, contagion arises when a comovement occurs, even when there are no global shocks and interdependence and fundamentals are not factors.

Based on Ogawa and Yang’s (2006) explanation, they seem worried about the former explanation in which “*competitive devaluation*” can threaten financial and economic relations within intra-regions. As stated in page 16:

“...a country’s devaluation (center) in the region, whether intended or unintended, will create more pressure on other countries’ devaluation (periphery). This will produce more currency deviation from the equilibrium level as well as more possible future volatile exchange rate movements in the region.”

In recent days, the possibility of “*competitive devaluation*” seems far from the reality in East Asian economies. In fact, most of EA countries have defended their currency to fluctuate (appreciate) by intervening heavily in the foreign exchange market. However, the idea of “*competitive devaluation*” should be focused on Japan and China. The huge amount of reserve built up by China has threatened the international competitiveness of Japanese goods. In other words, China heavily defended their currency from appreciating. For this particular reason, “*competitive devaluation*” might be a worry for Japanese economies as a big competitor of China due to the use of exchange rate policy to gain a competitive advantage in global trading.

Finally, Ogawa and Yang (2006) have pointed out “*the dilemma between asset and liability dollarization*” in EA countries. Actually, this concern should raise the importance of the stabilization of US Dollar in EA region. This is because when both Dollar liabilities and assets are high in a region, it means that this economy needs the stabilization of US Dollar. For example, the net creditor economies which have a considerable amount of foreign reserve in dollar denominated assets will suffer loss from the depreciation of US Dollar. By the same token, the net debtor economies will suffer loss from the appreciation of US Dollar because of their Dollar liability.

3. POLICY IMPLICATIONS

The previous section included an examination of 3 major concerns raised by Ogawa and Yang (2006) regarding to the exchange rate regime in East Asia. Generally, these 3 important points lead to a policy implication for East Asian to adopt intermediate exchange rate regimes or a “*Currency Basket Regime*”. However, the feasibility of this new regime has been increasingly questioned today.

There are, at least, four important issues regarding the implementation of common currency arrangement like “*Currency Basket Regime*” or CBR.

Firstly, the Currency Basket Regime can be identified as an intermediate exchange rate regime that is naturally unstable and crisis-prone in the era of high capital mobility. The reason is that intermediate exchange rate arrangements are more vulnerable to shift in market sentiment and more difficult to manage. Frankel et al. (2000) pointed out that most intermediate regimes are insufficiently “transparent” and it is hard to maintain credibility. This argument is strengthened by Calvo and Mendoza (2000) who note that the problem of “herding behavior” in global financial market can only be diminished by implementing a credible and transparent policy, such as: fixed exchange rate or floating exchange rate regime.

In addition, the problem that might arise from implementing intermediate targets is that policymakers and private agents are unable to undertake actions that would reduce the vulnerability of the economy to crisis. Predominantly, the domestic financial system will be more fragile due to the increasing of foreign borrowing which is triggered by the implicit guarantee of central bank to keep the exchange rate fixed. It will eventually create more risk currency exposure in the economy. Consequently, the vulnerability of the domestic financial system is likely to appear when countries adopt intermediate regimes. From this point of view, CBR idea as an option of the new regional exchange rate regime may be weak for EA economies. However, as a stepwise approach to monetary integration, this option can be implemented to facilitate EA members to get to know their potential partners and their policy preferences more closely.

Secondly, the implementation of CBR needs a strong political commitment among the members. This important issue needs to be resolved in order to solve some

hard economic policies regarding to the new currency arrangement. As pointed out by Volz (2006), the political commitment is important to solve some initial programs, such as: support fund, intervention rule design, surveillance program, credit program for central banks, the weight of CBR and term of reference for domestic exchange rate realignment.

Furthermore, the political commitment is also needed to resolve the problems that arise when the system is facing pressures which threatening its sustainability. European experience is a classic example of the importance of this issue. Following the German unification, the German government pursued expansionary excessive fiscal policy, with the consequence of rising inflation. The Bundesbank responded with a high interest rate policy actually has caused the Lira and Sterling to realign their exchange rate. This policy was needed because a high interest rate policy would have severely dampened their economies. In this respect, the crisis increased due to the lack of coordination among EU members. (Volz, 2006)

Thirdly, the implementation of CBR regime needs independent central banks and robust monetary rules. Establishing an independent central bank with strong inflation aversion is an important manner to keep down inflationary expectations. While beneficial for any economy, this is particularly important for countries with an external anchor, because central bank independence provides credibility to the peg. Regarding to this concern, the central bank of each member must be robust in terms of maintaining its consistency to peg to the new anchor. In other words, if their national policy and economic objectives become inconsistent with the common-basket peg, the system will be tested by speculators. In the last section, the distinction between De Jure and De Facto exchange rate regime in EA regions was highlighted. It can be summarized that for many EA countries, De Facto central bank independence still seems a long way off. Consequently, this weak condition should be a concern by EA authorities before implementing a new regime.

Fourthly, the issue about setting up the weight in the currency basket has become prominent. Actually, there is no simple set of trade weights that will give optimal results and no one really knows enough about the relevant parameters to modify the trade weights in a satisfactory way. The duty will be more difficult to

manage when groups in the region agree to adopt a common basket. Even if they choose to use trade weights, they might disagree about the size of weight, because their trade patterns are different. Take East Asia, as an example. Korea trades far more heavily with Japan than do most ASEAN countries. Within ASEAN itself, moreover, Indonesia and Thailand trade more heavily with Japan than with the United States, while Singapore trades more heavily with the United States. (Eichgreen, 2006)

Similar to this idea, Glick (2002) pointed out that the problems in deciding the currency weight in CBR is hard to implement in practice. He thought that the virtues of simplicity, observability and transparency are lost to the extent that weight are not published to the public and may change over time due to the structural changes. Consequently, this discretionary manipulation of weights is likely to undermine the credibility of the exchange rate regime.

4. CONCLUSION

This paper contains a critique of the Ogawa and Yang (2006) paper "The dilemma of exchange rate arrangement in East Asia". It pointed out several weaknesses of the Ogawa and Yang (2006) arguments in promoting the importance of coordination and management in EA economies. In short, they lack valid data and convincing argument that it is necessary for East Asian economies to develop a regional exchange rate system.

The idea of Currency Basket Regime promoted by Ogawa and Yang (2006) has a principal problem related to the weight in the basket. In addition, the risks associated with intermediate exchange rate regime will make this regime more crises prone. Consequently, the issue of maintaining political harmony and credibility of the regime is a vital role to ensure the sustainability of this regime.

The development of new exchange rate management in EA economies should not be considered partially. At first, it should be managed in line with the strategic interests of EA economies. In other words, this development needs a political harmony among them. Furthermore, this new arrangement has also to fit with their domestic policies. These important requirements are needed to push the enhancement of regional surveillance and macroeconomic coordination among EA economies. Secondly, the new

exchange rate regime needs a regional liquidity support arrangement to enforce the sustainability of the new regime. These two requirements are needed to protect the multilateral peg system from the speculative attack in the era of high capital mobility.

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