The East Asian Dollar Standard, Fear of Floating, and Original Sin

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Summary

Before the crisis of 1997-98, the East Asian economies—except for Japan but including China—pegged their currencies to the US dollar. To avoid further turmoil, the IMF now argues that these currencies should float more freely. However, our econometric estimations show that the dollar's predominant weight in East Asian currency baskets has returned to its pre-crisis levels. By 2002, the day-to-day volatility of each country's exchange rate against the dollar has again become negligible. In addition, most governments are rapidly accumulating a "war chest" of official dollar reserves, which portends that this exchange rate stabilization will come to extend over months or quarters. And, although Japan remains an important outlier, their joint pegging to the dollar benefits trade in the East Asian dollar bloc as a whole.

From the doctrine of "original sin" applied to emerging-market economies, we argue that this fear of floating is entirely rational from the perspective of each individual country. In a world where most trade is invoiced in dollars but domestic financial markets are incomplete so that hedging against foreign exchange risk is difficult and expensive, governments provide forward cover informally by simply keeping the spot rate against the dollar fairly constant through time. However, because some imports into the smaller East Asian economies are invoiced in yen or euro, importers may be vulnerable to extraneous exchange rate risk—as when the yen fluctuates against the dollar. But we show that hedging against this extraneous exchange rate risk is possible by using the well-developed forward market between yen and dollars, as long as the importer knows that his own currency is like to stay quite stable against the dollar. And this method of hedging foreign exchange risk dominates oft advocated— but still hypothetical— basket pegging, where the spot exchange rate is tied to a trade-weighted basket of the major currencies.