Int. Fin. Markets, Inst. and Money 20 (2010) 149–165

Contents lists available at ScienceDirect

Journal of International Financial Markets, Institutions & Money

journal homepage: www.elsevier.com/locate/intfin

Assessing co-ordinated Asian exchange rate regimes: Proposal for a possible move towards a common currency

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ARTICLE INFO

Article history:
Received 16 October 2009
Accepted 26 January 2010
Available online 2 February 2010

JEL classification:
F02
F31
F33
F42

Keywords:
Asia
Basket exchange rates
Currency pegs
Exchange rate regimes

ABSTRACT

This study assesses prospective Asian exchange rate regimes and finds short- and long-run currency dynamics more conducive to the introduction of a common peg based on a basket of the European euro, the United States dollar and the Japanese yen than the alternative of a United States dollar peg exchange rate regime. Exchange rate systems of 3- 4- and 5-Asian currencies are considered and the dynamics in a set of four European currencies prior to the introduction of the Euro provides benchmark evidence. The evidence for an Asian basket peg exchange rate regime is strengthened when, unlike prior studies, estimates of the long-run parameters account for time-varying volatility effects.

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1. Introduction

One of the reasons given for the recent (2008) global financial crises is the presence of persistent imbalances in international financial flows. It has been noted that many Asian countries have savings rates that are considered too high, resulting in the accumulation of large foreign exchange reserves by these countries. In addition, the US is forced to run huge international deficits to supply the financing needed for world trade, especially exports from these Asian countries. It is further contended that much of this problem of imbalances in global financial flows originates in some Asian exchange rates

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doi:10.1016/j.intfin.2010.01.002

that are semi-fixed at unrealistic levels. Thus, the nature of exchange rate regimes in Asia has been and continues to be a very important issue.

There is ongoing debate regarding the merits and disadvantages of fixed versus flexible exchange rates with respect to realising the objectives of Asian financial stability, economic development, and sustained economic growth (see, Frankel, 1999; Fischer, 2001; Guillermo and Mishkin, 2003; Huang and Guo, 2006; Jeon and Zhang, 2007). While flexible exchange rates allow greater macroeconomic policy freedom, fixed exchange rates facilitate the economic integration between cooperating countries. This 'two-corner solution' debate, however, has become less compelling in recent years in light of the revealed vagaries of foreign exchange markets (see Meese and Rogoff 1983; Frankel and Rose, 1996; Froot and Ramadorai, 2005). Furthermore, Esaka (2009) finds no evidence that, as the 'two-corner solution' argues, intermediate exchange rate regimes have a significantly higher probability of currency crises than both hard pegs and free floats.

In this vein, an important strand of the extant literature examines relevant macroeconomic criteria, *e.g.*, the level of correlation of economic shocks and the level of intra-regional trade (see Mundell, 1961; McKinnon, 1963), and advocates the inception of a more co-ordinated Asian exchange rate regime as an interim step towards an optimal currency area (see Eichengreen and Bayoumi, 1996; Ling, 2001; Huang and Guo, 2006). A recent example is Shirono (2008), who estimates trade-creating effects and welfare effects of various common currency arrangements in East Asia using a gravity model with bilateral trade data for 1980 and 1990. The study finds that a single currency in East Asia will stimulate regional trade substantially and regional currency arrangements can generate economically significant welfare gains for the region. However, while these studies show the potential benefits of a currency union, they have not assessed either the optimal construction or the feasibility of forming such a currency union.

Virtually all of the Asian authorities appear to have traditionally followed a United States dollar standard at some point in the past (see Frankel and Wei, 1994; McKinnon and Schnabl, 2004; Kearney and Muckley, 2007). However, the growing intra-Asian trade and investment linkages have largely eroded the significant merit of that system with respect to price stability, financial market and trade integration, and current account imbalances, culminating (in part) in the Asian financial crisis of 1997–1998 (see Ito et al., 1998; Kwan, 2001; McKinnon and Schnabl, 2003; McKinnon, 2006). Chow et al. (2007) find that the role of the U.S. dollar has declined recently in East Asia after the 1997 crisis while that of the yen and other currencies remains mostly the same. In addition, the volatility of the US dollar–Japanese yen exchange rate, particularly in recent years, has weakened the desirability of a United States dollar based exchange rate system for Asia. As a result, a reversion to the dollar standard in Asia implies undesirable fluctuations in effective trade weighted exchange rates, unless the exchange rates of important trading partners are stabilised relative to one another. However, this seems unlikely (see Engelmann et al., 2008).

Alternative hypotheses concerning the likelihood of a reversion to a United States dollar peg exchange rate regime are also present in the literature. Specifically, it is reported that the East Asian economies have pursued a strategy of development based on currency under valuation with a view to stimulating exports and hence trade surpluses (see Dooley et al., 2004). Alternatively, McKinnon and Schnabl (2004) and McKinnon (2007) indicate that the East Asian economies may be ineluctably trapped into experiencing trade surpluses on the current accounts of their international balance of payments as a result of their high savings rates and a reluctance to allow their currencies to appreciate relative to the United States dollar with a resulting accumulation of dollar denominated assets by these economies. However, as noted earlier, this imbalance in global financial flows is unsustainable in the long run (Bergsten, 2009).

Thus, there are a number of reasons to re-examine the feasibility of a currency union in Asia. First, in the last couple of decades, the economic situation of various countries in Asia has changed significantly. While the Japanese economy has long stagnated ("lost decade"—now two lost decades) and its real income has even declined at times, East Asian economies have continued to grow impressively despite the 1997 currency crisis. While it is undeniable that Japan is still a dominant economy in East Asia, the economic footing of Japan relative to its neighbouring countries, has declined in relative terms so as to raise questions as to whether there is any room for Japan to play a significant role in the exchange rate policy in East Asia, especially in terms of forming a currency union among East Asian

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