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Impact of exchange rate volatility on Indonesia's trade performance in the 1990s

Reza Siregar * and Ramkishen S. Rajan

School of Economics, University of Adelaide, Australia

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Whether a real devaluation ultimately proves to be *expansionary* or *contractionary* depends on whether the boost given to the exportables sector offsets any possible output-depressing effects that may accompany the expenditure-switching policy. Failure of the exportables sector to adequately respond to the price incentives is a virtual guarantee that devaluation will be contractionary. This appears to have been the experience of Indonesia, the country worst hit by the crisis of 1997–1998. This paper explores whether the increased exchange rate variability of the Indonesian rupiah post 1997 may have been a cause for the country's poor export performance. *J. Japanese Int. Economies* **18** (2) (2004) 218–240. School of Economics, University of Adelaide, Australia.
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* Corresponding author.
E-mail addresses: reza.siregar@adelaide.edu.au (R. Siregar), ramkishen.rajan@adelaide.edu.au (R.S. Rajan).

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1. Introduction

The spate of financial crises in emerging economies over the last decade has often resulted in the collapse of US dollar pegs. While pegs have sometimes been "hard," more often than not they have been "soft" in the sense of not being backed by any institutional arrangements. This was the case in Southeast Asia in 1997–1998. In principle, Thailand and the other regional countries were supposed to have adopted basket pegged regimes, with the US dollar, Japanese 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*, leading McKinnon (2001) and others to make frequent reference to the region's "dollar standard" (Table 1; also see Ito et al., 1998, and Rajan, 2002).

A great deal of attention has been paid to the factors that have led to the crisis and eventual devaluation (i.e., are crises "self-fulfilling" or "fundamentals-based"?).[1] There is also growing recognition of the need to better comprehend the post devaluation output dynamics (Rajan, 2001). While the first and second genre of models may disagree about why a crisis occurs, both are agreed that the devaluation signals the end of the crisis; the nominal devaluation, if translated into a real one, will give a much needed boost to the

Table 1
The Southeast Asian dollar standard (daily nominal exchange rate)

Currencies	USD coefficient β_2 (standard error)	R-square
	Pre-crisis period (January 1994–May 1997)	
Indonesian rupiah	0.999 (0.008)	0.965
Malaysian ringgit	0.886 (0.014)	0.889
Philippines peso	0.987 (0.018)	0.836
Singapore dollar	0.817 (0.012)	0.905
Thailand baht	0.955 (0.012)	0.923
	Crisis period (June 1997–December 1998)	
Indonesian rupiah	0.550 (0.388)	0.038
Malaysian ringgit	0.755 (0.138)	0.161
Philippines peso	0.788 (0.125)	0.196
Singapore dollar	0.727 (0.061)	0.447
Thailand baht	0.688 (0.165)	0.107
	Post-crisis period (January 1999–May 2000)	
Indonesian rupiah	0.848 (0.163)	0.182
Malaysian ringgit	1.000 (0.000)	1.000
Philippines peso	0.945 (0.040)	0.741
Singapore dollar	0.818 (0.026)	0.848
Thailand baht	0.858 (0.049)	0.639

Notes. Regression model: $\%(\Delta\text{local currency/SF}) = \beta_1 + \beta_2(\%\Delta\text{USD/SF}) + \beta_3(\%\Delta\text{JPY/SF}) + \beta_4(\%\Delta\text{DM/SF}) + e_t$. USD = US$; JPY = Japanese yen; DM = German DM, and SF = Swiss Franc.
Source: (McKinnon, 2001).

[1] Focus here is solely on currency crises leading to a devaluation, i.e. "successful speculative attacks."

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