Trade and Financial Interdependence Under Flexible Exchange Rates: The Pacific Area

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WORKING PAPER 1517

DOI 10.3386/w1517

ISSUE DATE December 1984

This paper analyses policy interdependence under flexible exchange rates and its implications for middle-income countries in the Pacific area. In the first part of the paper, the consequences of strategic behavior among industrial countries are illustrated by means of a simple diagram. It is argued that in the absence of incentives to coordinate macroeconomic policies among major countries, exchange rates will tend to be volatile. Evidence on the world value of the dollar in the flexible rate period is then presented and interpreted.The second part describes exchange rate policies in the Pacific area. It is found that the widespread policy of pegging to the U.S. dollar has implied occasional large devaluations against the numeraire (Korea, Taiwan, Thailand, Philippines and Indonesia). An alternative, which requires higher Pacific trade and financial interdependence than the one prevailing during the last decade, would be a joint float along the lines of the policies seemingly pursued by Malaysia and Singapore.The two-country macroeconomic model presented in the Appendix can be used to assess the costs and benefits of policy coordination both at the world and at the regional level.

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Acknowledgements and Disclosures

Citation and Citation Data

Published Versions

de Macedo, Jorge Braga. "Trade and Financial Interdependence Under Flexible Exchange rates: The Pacific Area." Pacific Growth and Financial Interdependence, edited by Augustine H. H. Tan and Basant Kapur, pp. 277-291. Sydney, Australia: Allen Unwin Australia Pty Ltd, 1986.

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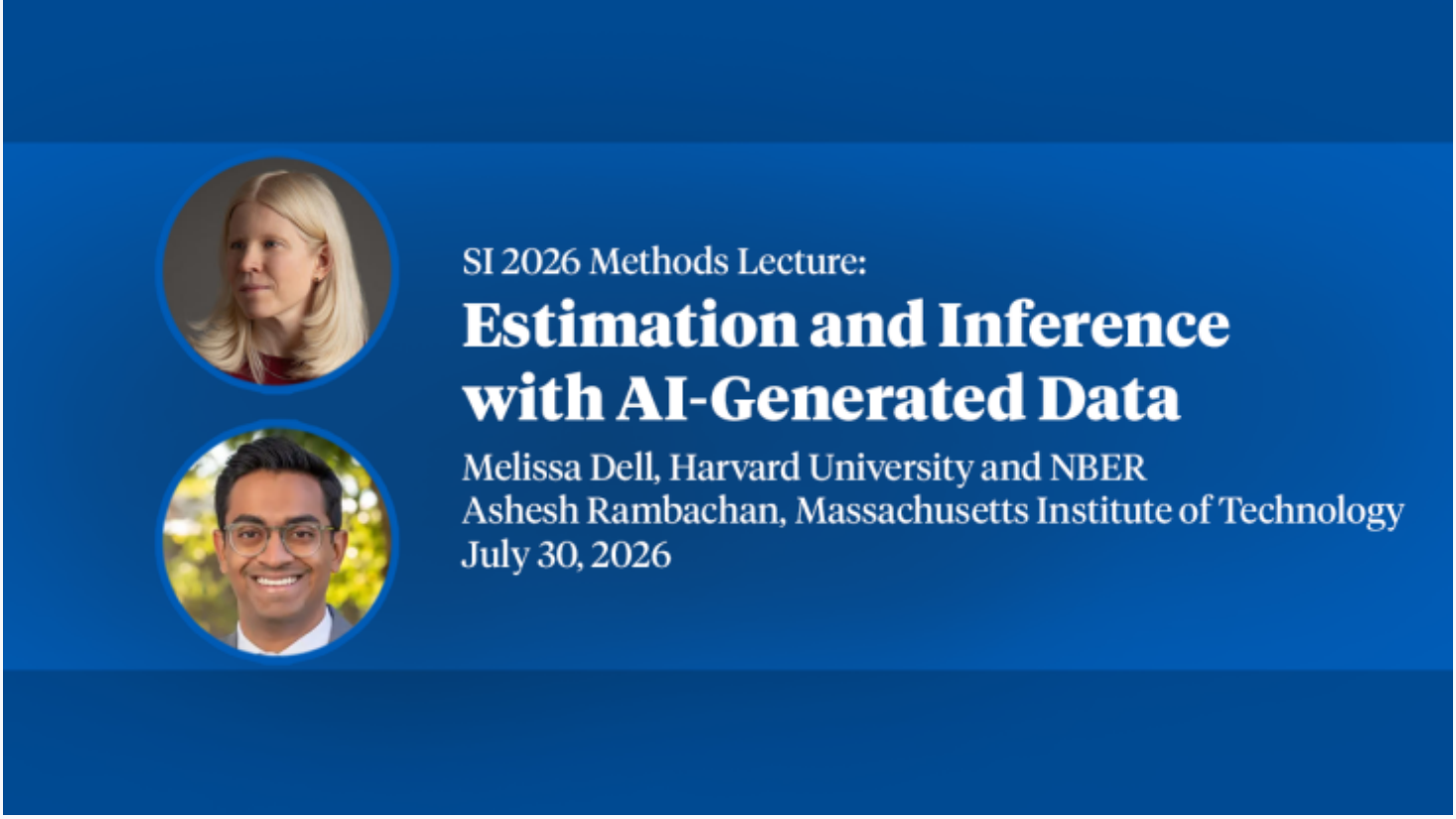


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