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

Jorge Braga de Macedo

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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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National Bureau of Economic Research

Contact Us

1050 Massachusetts Avenue
Cambridge, MA 02138
[617-868-3900](tel:617-868-3900)
info@nber.org
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