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

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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* ●●● (●●●) (●●●) ●●●-●●●. Department of Economics, National University of Singapore, Singapore; School of Economics, University of Adelaide, Australia; Institute of Southeast Asian Studies, Singapore.

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1 **1. Introduction** 1

2
3 The spate of financial crises in emerging economies over the last decade has often
4 resulted in the collapse of US dollar pegs. While pegs have sometimes been “hard,” more
5 often than not they have been “soft” in the sense of not being backed by any institutional
6 arrangements. This was the case in Southeast Asia in 1997–1998. In principle, Thailand
7 and the other regional countries were supposed to have adopted basket pegged regimes,
8 with the US dollar, Japanese yen and other currencies receiving weights consistent with
9 their respective significance in economic linkages with the Southeast Asian countries.
10 However, in reality, the US dollar had the overwhelming weight *de facto*, leading
11 McKinnon (2001) and others to make frequent reference to the region’s “dollar standard”
12 (Table 1; also see Ito et al., 1998, and Rajan, 2002).

13 A great deal of attention has been paid to the factors that have led to the crisis and
14 eventual devaluation (i.e., are crises “self-fulfilling” or “fundamentals-based”?).¹ There is
15 also growing recognition of the need to better comprehend the post devaluation output
16 dynamics (Rajan, 2001). While the first and second genre of models may disagree about
17 why a crisis occurs, both are agreed that the devaluation signals the end of the crisis; the
18 nominal devaluation, if translated into a real one, will give a much needed boost to the
19

20
21
22 Table 1
23 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

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41 Notes. Regression model: $\%(\Delta \text{local currency}/\text{SF}) = \beta_1 + \beta_2(\% \Delta \text{USD}/\text{SF}) + \beta_3(\% \Delta \text{JPY}/\text{SF}) +$
42 $\beta_4(\% \Delta \text{DM}/\text{SF}) + e_t$. USD = US\$; JPY = Japanese yen; DM = German DM, and SF = Swiss Franc.
43 Source: (McKinnon, 2001).

44
45 ¹ Focus here is solely on currency crises leading to a devaluation, i.e. “successful speculative attacks.” 45

1 exportables sector and thus aggregate output.² This was the case in Brazil, for instance, 1
 2 following the devaluation of the real in January 1999. On the other hand, the experiences of 2
 3 Mexico, East Asia and elsewhere have, by all indications, been quite painful, with severe 3
 4 output losses. These events have awakened us to the idea that there may be an intense 4
 5 recessionary threat associated with devaluation, at least in the short-term (Rajan and Shen, 5
 6 2001). Thus, Dooley and Walsh (2000) have recently commented “(w)e are unsure why 6
 7 some crises are followed by... periods of economic recession while others are not” (p. 3). 7

8 While there are a multitude of channels via which a devaluation could be contractionary 8
 9 (Bird and Rajan, 2001, and Rajan and Shen, 2001), whether a devaluation ultimately 9
 10 proves to be expansionary or contractionary depends on whether the boost given to the 10
 11 exportables sector offsets the output-depressing effects (Krugman, 1999). Any failure of 11
 12 the exportables sector to adequately respond to the price incentives is a virtual guarantee 12
 13 that devaluation will be contractionary. This appears to have been the experience of 13
 14 Indonesia, the country worst hit by the crisis of 1997–1998 (Fig. 1). Far from stimulating 14
 15 export growth, a severe depreciation of the rupiah against the US dollar in 1997–1998 15
 16 resulted in an outright collapse of the country’s exports (Figs. 2 and 3). Despite the fact 16
 17 that the rupiah fell by an average of 0.8 percent *per day* in nominal terms (against the 17
 18 US dollar) between July 1997 and January 1998, Indonesia’s total exports of merchandise 18
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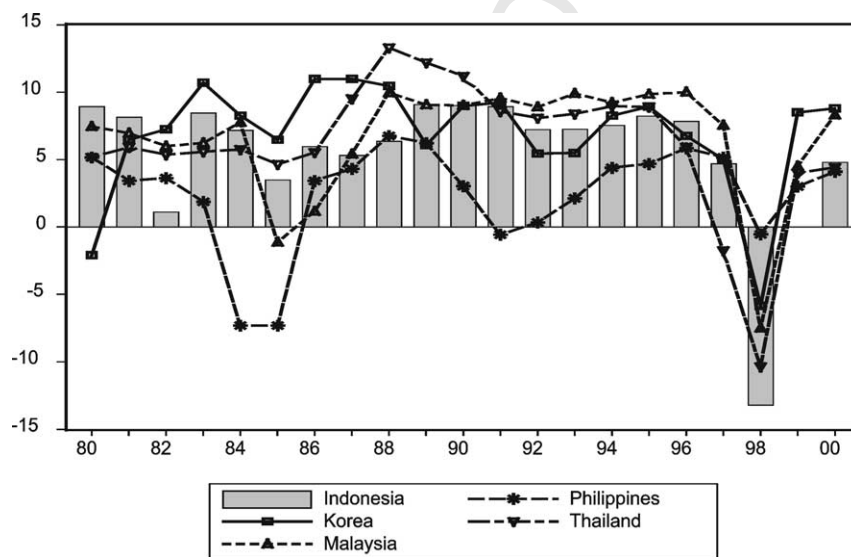


Fig. 1. GDP growth rate of selected 1997-crisis effected Asian economies (1980–2000).

² For instance, Rodrik (2000) has noted “there is every reason to think that..(the).. real depreciations were an important boost to economic activity, particularly in tradables, and not simply something that went alongside higher growth. They unleashed energies and focused them on world markets, boosted exports, and set the stage for economic transformation” (pp. 8–9).

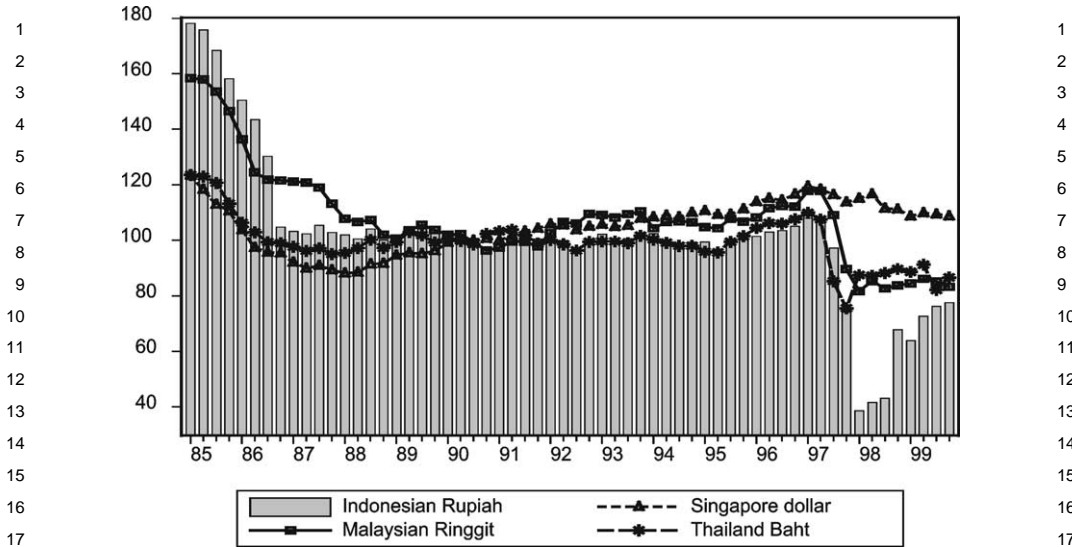


Fig. 2. REER of selected 1997-East Asian crisis affected economies

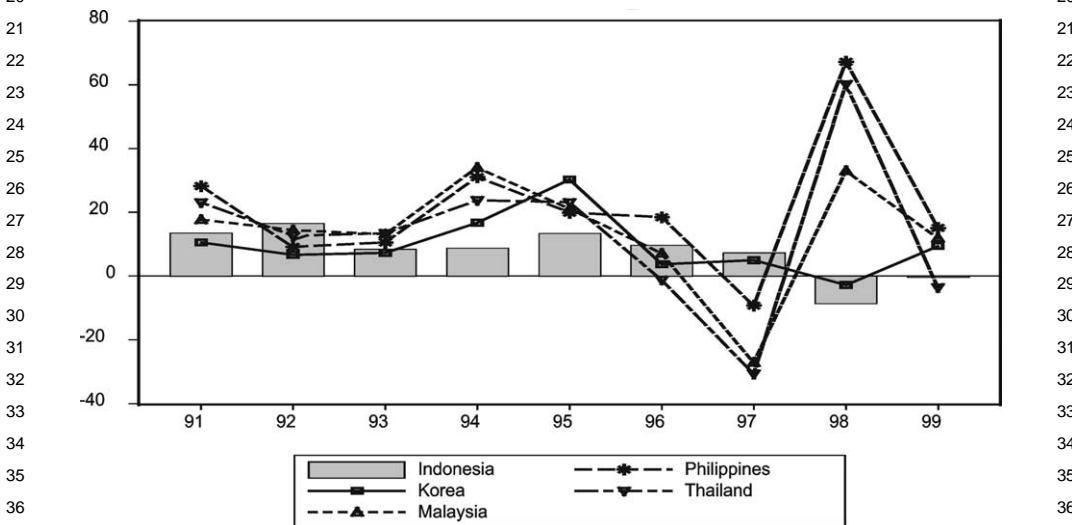


Fig. 3. Growth rates of exports of selected East Asian economies (1991-1999).

goods (in US dollars) declined by 8.5 percent at the end of 1998 compared to 1997.³ In volume terms, Indonesia's merchandise exports experienced an average annual drop of

³ For Indonesia, merchandise trade contributed over 85 percent of the country's total exports of goods and services (in US dollar) annually in the 1990s.

1 14 percent between Q2: 1998 and Q1: 1999, with the worst annual decline occurring in the 1
2 last quarter of 1998 (close to 20 percent).⁴ 2

3 There is, of course, the open question as to whether Indonesian exports comply with 3
4 the Marshall-Lerner conditions. Studies for emerging economies have generally found 4
5 foreign trade price elasticities to be sufficient to ensure an improvement in the trade account 5
6 (Wilson, 2001). To the best of our knowledge, no study has focused specifically on the trade 6
7 performance of Indonesia during the recent crisis.⁵ However, it is revealing to note that 7
8 rupiah devaluations in the recent past have helped stimulate exports. For instance, despite 8
9 a rupiah devaluation of around 28 percent against the US dollar in early 1983, the non-oil 9
10 exports (in US dollar) grew by 27 percent that year and 17 percent in the next, compared to 10
11 a decline of 13 percent in 1982. When the rupiah was again devalued by 31 percent in 11
12 September 1986 to counter the export stagnation, non-oil exports (in US dollar) rose by 12
13 11 percent in that year and over 30 percent in each of the next two years (Rosner, 2000). 13
14 So devaluations in Indonesia have historically provided the necessary export and growth 14
15 impetus. There was no such export lift in 1997-1998. Why? There are two reasons that 15
16 have most commonly been offered. 16

17 First, Indonesia was not alone in devaluing its currency, other regional economies also 17
18 simultaneously doing so. The rupiah devaluation may have failed to boost exports as no 18
19 significant competitive price advantage may have accrued to Indonesia (i.e. phenomenon 19
20 of "competitive devaluations"). Duttagupta and Spilimbergo (2000) find that competitive 20
21 devaluation played a key role in exacerbating the real effects of the crisis in the East 21
22 Asia through the trade channel. Second, given the recessionary conditions faced by the 22
23 region, even if there was any positive price effect on exports, it may have been more than 23
24 offset by negative income effects. However, these caveats ought to apply as much to the 24
25 other crisis-hit Southeast Asian economies as they might to Indonesia. For comparison, 25
26 merchandise exports of Malaysia, the Philippines, and Thailand experienced sharp falls in 26
27 1997 by 27 percent, 9 percent and 30 percent, respectively. But in 1998, exports rebounded 27
28 in all three economies, with impressive rates of 33 percent for Malaysia, 67 percent for 28
29 the Philippines, and 60 percent in the case of Thailand (all in US dollar terms) (Fig. 3). 29
30 Indeed, the US dollar value of Indonesia's merchandise exports in 1999 was still below 30
31 its level in 1996, unlike the three neighboring economies. This suggests a need for an 31
32 alternative rationalisation for Indonesia's abysmal export performance post-devaluation. 32
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34 Two obvious explanations for this disappointing export performance appear to be 34
35 favored by policy makers. First, that the collapse of the domestic financial sector which 35
36 accompanied the currency collapse (due to the balance sheet effects as well as an 36
37 outright bank panic) caused severe cuts in trade finance and prevented local producers 37
38 taking advantage of the depreciated rupiah (Pardede, 1999). Second, there were adverse 38
39 movements in the terms of trade of several of the country's key export commodities 39
40 (Rosner, 2000). 40

41
42 ⁴ Exports in rupiah terms contracted by about 40 percent in 1998 and 1999. 42

43 ⁵ Duttagupta and Spilimbergo (2000) include exports data for Indonesia in their panel data of six East Asian 43
44 countries' exports to examine the implications of exchange rate depreciations in the region on the countries' 44
45 exports. 45

1 While there may well be an element of truth in both these reasons, another plausible 1
2 explanation that has hitherto remained unexplored is the role of real exchange rate 2
3 volatility. To be sure, past devaluations in Indonesia were all controlled ones in the sense 3
4 that they involved a re-pegging of the rupiah at a new rate to the US dollar. In contrast, 4
5 the devaluation of 1997–1998 was followed by a massive shift to one of relatively greater 5
6 regime flexibility (Fig. 2).⁶ There has concomitantly been an intensification in the country's 6
7 real exchange rate volatility which in turn may have had a detrimental impact of Indonesia's 7
8 trade. As will be discussed in more detail, estimates of conditional variance confirm that 8
9 the volatility of the real effective exchange rate of rupiah between February 1998 and July 9
10 2001 increased by more than thirty five times from its average in January 1994 to June 10
11 1997. 11

12 The aim of this paper is to test these *price*, *income*, and *volatility* channels by estimating 12
13 a set of export and import functions for Indonesia. In particular, we are interested in 13
14 understanding the implication of the volatility of rupiah's real exchange rate on both the 14
15 country's exports and imports. This is the basic question we try to answer in this paper. An 15
16 important caveat is in order. The economic crisis faced by Indonesia has been accompanied 16
17 by an acute political crisis and instabilities which in turn further deepened the overall 17
18 economic crisis (Rosner, 2000 and Siregar, 2001). The simultaneous economic and socio- 18
19 political turmoil in 1998 invariably tends to contaminate the data and analysis, clearly 19
20 making it extremely difficult to separate the role of exchange rate volatility and other 20
21 crisis related factors in explaining the performance of exports and imports of Indonesia. 21
22 Therefore, in order to address the important policy issue at hand, we choose to concentrate 22
23 our analysis on the pre-crisis period between Q1: 1980 and Q2: 1997. We then extrapolate 23
24 the conclusions reached for this period to the post-crisis period to answer the question as 24
25 to whether the rise in currency volatility during the post-1997 crisis might be expected to 25
26 adversely hamper the performance of Indonesia's trade, especially in 1998 and 1999. The 26
27 more stable and conducive political environment in the pre-1997 period ought to provide 27
28 us with a more reliable set of results that will be useful in understanding the post-crisis on 28
29 goings in Indonesia. 29

30 The remainder of the paper is organized as follows. The next section offers a brief 30
31 overview of the main empirical literature on the impact of exchange rate volatility on 31
32 trade. Section 3 is devoted to describing the data series and defining the various terms and 32
33 variables to be used in the empirical analysis. We pay particular attention to defining and 33
34 measuring exchange rate volatility. We construct two commonly used measurements of 34
35 exchange rate volatility, viz. a Moving Average standard deviation introduced by Kenen 35
36 and Rodrik (1986) and a GARCH model. Discussions on Johansen cointegration test 36
37 results are provided in Section 4. The roles of the two volatility indices on Indonesia's 37
38 total non-oil merchandise exports and imports are both considered. To further enhance 38
39 our analysis on non-oil merchandise imports we decompose imports into capital and 39
40 40

41 ⁶ Officially, Indonesia is supposed to be pursuing a floating regime with monetary policy anchored by an 41
42 inflation target (see the various Letters of Intent (LOIs) between Indonesia and the IMF are available on the 42
43 latter's website: www.IMF.org). However, in terms of actual implementation of the monetary-cum-exchange rate 43
44 policy, the country's central bank, Bank Indonesia, has often time expressed its commitment to do everything in 44
45 its power to prevent rupiah from further sliding (against the US dollar) in late 2001 (Siregar, 2001). 45

1 intermediate products. We also specifically test the impact of currency volatility on
2 Indonesia's bilateral merchandise exports to Japan and imports from Japan (which is
3 Indonesia's single largest trading partner). The final section offers a summary section and
4 some concluding observations.

5 6 7 **2. Literature survey**

9 Is currency volatility harmful to international trade? This seemingly straightforward
10 question has in fact been among the most elusive to answer in international economics.
11 Theory is highly ambiguous on the issue (Rahmatsyah et al., 2002). Accordingly, as with
12 most other things, it is an empirical issue. In a comprehensive survey of the literature on
13 the impact of exchange rate volatility on trade flows, Mckenzie (1999) concludes that the
14 recent empirical studies have had "greater success in deriving a statistically significant re-
15 lationship between volatility and trade" (p. 100). Calvo and Reinhart (2000) review a more
16 limited set of such studies and reach a similar conclusion.⁷ While a large number of these
17 empirical studies have shown negative impacts of exchange rate volatility on total trade,
18 exports and imports, some have also reported positive and insignificant consequences.

19 Table 2 highlights a number of recent studies on the issue. Only Chowdhury (1993)
20 and Caporale and Doroodian (1994) report consistently adverse consequences of exchange
21 rate volatility on exports and imports. Other studies such as by Klein (1990), Mckenzie
22 (1998), Bailey, Tavlas and Ulan (1987), Koray and Lastrapes (1989), Asseery and Peel
23 (1991), Kroner and Lastrapes (1993), Mckenzie and Brooks (1997), Mckenzie (1998),
24 Daly (1998), Wei (1999), and Chou (2000) have found cases where a rise in exchange
25 rate volatilities may have both positive and negative implications on exports and imports,
26 depending on products' and countries' cases. However, these conclusions cannot be seen
27 as definitive. There are also a few studies which conclude that exchange rate volatility
28 plays no significant role in explaining exports and imports. This includes a recent study by
29 (Aristotelous, 2001) that finds exchange rate volatility has not had any significant impact on
30 the performance of the British exports to the United States during the period of 1889–1999.
31 All in all, the empirical literature has reaffirmed the ambiguous nexus between currency
32 volatility and trade as indicated by the theoretical literature on the subject.

35 **3. Model, data, and definitions**

36 37 *3.1. Export and import demand functions*

38
39 There are two primary determinants of export and import demand (Dornbusch, 1988,
40 and Hooper and Marquez, 1993). First, is the foreign income variable which measures

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42
43 ⁷ Another recent set of empirics by Andrew Rose based on gravity models using both cross-sectional and
44 time series data suggests institutionally fixed exchange regimes (i.e. common currency, currency boards or
45 dollarization) stimulates trade, which in turn boosts income (see Frankel and Rose, 2001; Glick and Rose, 2001
and Rose, 2000).

References	Country/sample period	The effect of ER volatility to trade
Hooper and Kohlhaugen (1978)	Germany, Japan, United Kingdom, United States, Canada, France (bilateral trade). 1965.1-1975.4	X: Significant negative relationship in 2 equations, significant positive relationship in 4 equations and insignificant in 26 equations.
Rana (1981)	South Korea, Philippines, Thailand, and Taiwan (multilateral trade). 1960.1-1976.4	M: Significant negative relationship in 4 equations and insignificant for 1 equation for the pegged period in Taiwan equation.
IMF (1984)	United States, United Kingdom, France, Germany, Italy, Canada, and Japan (bilateral trade). 1965.1-1982.4	X: Significant negative relationship in 3 equations, significant positive relationship in 11 equations and insignificant in 28 equations.
Kenen and Rodrik (1986)	US, Canada, Japan, Belgium, France, Germany, Italy, Netherlands, Sweden, Switzerland, UK (multilateral trade). 1975.1-1984.2	M: Significant negative relationship in 4 equations and insignificant in 7 equations.
Bailey, Tavlas and Ulan (1987)	Canada, France, Germany, Italy, Japan, UK, USA, Australia, New Zealand, Netherlands, Switzerland (multilateral trade). 1962.2-1974.4 and 1975.1-1985.3	X: Significant negative relationship in 3 equations, significant positive relationship in 5 equations and insignificant in 34 equations.
Thursby and Thursby (1987)	Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Italy, Japan, Netherlands, Norway, South Africa, Sweden, Switzerland, United Kingdom, and United States (bilateral trade). 1974-1982 (annually)	X: Significant negative relationship in 10 equations.
Cushman (1988)	USA (bilateral trade). 1974 - 1983 (annually)	X: 2 of 6 equations have a significant negative effect and 1 has a significant positive effect. M: 5 of 6 equations have a significant negative effect.
Koray and Lastrapes (1989)	USA with UK, France, Germany, Japan, Canada (bilateral trade). 1959.01-1985.12	M: Significant negative relationship in 41 equation, significant positive relationship in 16 equations and insignificant in 39 equations.
Lastrapes and Koray (1990)	USA (multilateral trade). 1973.03-1987.12	X, M: Significant negative relationship in 6 equations and insignificant in 42 equations.
Klein (1990)	USA with Netherlands, Canada, Japan, France, Italy, Germany (sectoral analysis in bilateral trade). 1978.01-1986.12	X: Significant negative relationship in 4 equations, significant positive relationship in 7 equations and insignificant in 43 equations.
Asseery and Peel (1991)	Australia, Japan, UK, USA, West Germany (multilateral trade). 1972.1-1987.4	X: Significant negative relationship in 1 equation, significant positive relationship in 2 equations and insignificant in 3 equations.
Bini-Smaghi (1991)	Italy, France, Germany (multilateral trade of the manufacturing sector). 1976.1-1984.4	X: Significant negative relationship in 13 equations and insignificant in 11 equations.
Chowdhury (1993)	Canada, France, Germany, Italy, Japan, UK, USA (multilateral trade). 1973.1-1990.4	X: Significant negative relationship in all 7 equations.

1 Table 2 (Continued)

2	References	Country/sample period	The effect of ER volatility to trade	2
3	Kroner and Lastrapes (1993)	USA, UK, France, Germany, Japan (multilateral trade). 1973.05-1990.11	X: Significant negative relationship in 3 equations, significant positive relationship in 1 equation and insignificant in 1 equation.	3
4	Caporale and Doroodian (1994)	USA to Canada (bilateral trade). 1974.01-1992.10	M: Significant negative relationship.	4
5	Mckenzie and Brooks (1997)	German to USA (bilateral trade). 1973.04-1992.09	X: 4 equations have a positive effect (but insignificant). M: 4 equations have a significant positive effect.	5
6	Mckenzie (1998)	Australia (multilateral, bilateral and sectoral trade). 1969.3-1995.4	X: Generally have a positive effect. M: 5 of 6 generally have a negative effect.	6
7	Daly (1998)	Japan (bilateral trade). 1978.1-1992.2	X: 4 equations have a positive effect and 3 equations have a negative effect. M: 5 equations have a positive effect and 2 equations have a negative effect (overall likely to have a positive correlation).	7
8	Wei (1998)	63 countries in the world (bilateral trade). 1975, 1980, 1985, 1990	X, M: Pooled equation: in 1975 and 1980 has significant negative effect; in 1985 has insignificant positive effect; in 1990 has significant positive effect. Panel equation: significant positive effect.	8
9	Chou (2000)	China (multilateral and sectoral trade). 1981.1-1996.4	X: Negative effect on total export, export of manufacture goods and mineral fuels. Positive effect on export of industrial materials.	9
10	Aristotelous (2001)	UK to USA (bilateral trade). 1889-1999	X: Neither exchange-rate volatility nor the different exchange rate regimes had an effect on export volume.	10

11 Notes. X refers to export model; and M refers to import model.

12 Source: compiled by authors.

13 the economic activity and the purchasing power of the trading partner country (“income effect”). Second, is the relative price or the terms of trade variable (“price effect”). As noted, exchange rate volatility is an additional factor that needs to be explicitly taken into account (“volatility effect”). Incorporating all of the determinant factors, we can derive the following set of simple export and import-demand functions:

$$14 \quad x_t = \alpha_{11} + \alpha_{21} y_t^{\text{foreign}} + \alpha_{31} p_t + \alpha_{41} V_t + \varepsilon_{1t}, \quad (1)$$

$$15 \quad m_t = \alpha_{12} + \alpha_{22} y_t^{\text{local}} + \alpha_{32} p_t + \alpha_{42} V_t + \varepsilon_{2t}, \quad (2)$$

16 where x_t is the natural logarithm of export volume, m_t is the natural logarithm of import volume, y_t^{foreign} is the natural logarithm of real foreign/world GDP, y_t^{local} is the natural logarithm of domestic real GDP, p_t is the terms of trade, V_t is volatility of the real exchange rate.

1 According to our theoretical priors, the volume of exports (imports) to a foreign country
2 (domestic country) ought to increase as the real income of the trade partner (domestic
3 economy) rises, and vice versa. So we expect $\alpha_{21} > 0$ and $\alpha_{22} > 0$. A rise (fall) in the
4 terms of trade will cause the domestic goods to become less (more) competitive than
5 foreign goods, therefore exports will fall (increase) and imports will rise (fall). So we
6 expect $\alpha_{31} < 0$ and $\alpha_{32} > 0$. As discussed previously, the impact of exchange rate volatility
7 on exports and imports is ambiguous, i.e. α_{41} and α_{42} could either be positive or negative.
8

9 3.2. Data

10
11 As briefly mentioned in the Introductory section, we conduct three sets of tests on the
12 working models (Eqs. (1) and (2)), all with the aim of trying to decipher the impact of the
13 role of exchange rate volatility on Indonesia's trade performance. The first test is applied
14 on Indonesia's total imports and exports. The second test decomposes imports into its
15 two main components, viz. intermediate imports and capital imports. The third set reports
16 the regression results of Indonesia's bilateral exports and imports with its largest trading
17 partner, Japan.

18 All raw data are of quarterly frequency and are taken from the *International Financial*
19 *Statistics* (IMF, 2000) and the *OECD Statistical Compendium* (CD ROM), except for
20 capital and intermediate imports which are sourced from the *Central Bureau of Statistics*
21 *of Indonesia*. To recap, this study covers the period from the 1980s (depending on data
22 availability) until the second quarter of 1997; the post-1997 crisis period is excluded to
23 avoid any structural breaks in the data.
24

25 3.3. Definitions

26 3.3.1. Trade volume

27 For total exports and imports we have adopted the series in quantity or volume terms.⁸
28 While volume data for Indonesia's aggregate exports and imports are available, this is not
29 the case for bilateral trade. Thus, in order to obtain the volume of Indonesia's trade with
30 Japan (which, as noted, is needed for the third set of tests), we divide the available value
31 series of bilateral trade by an appropriate price index (both are in US dollars):
32

$$33 X_t^{JP} = \frac{XVAL_t^{JP}}{XP_t}, \quad (3)$$

$$34 M_t^{JP} = \frac{MVAL_t^{JP}}{XP_t^{JP}}, \quad (4)$$

35 where X_t^{JP} is the quantity of Indonesia's exports to Japan; M_t^{JP} is the quantity of
36 Indonesia's imports from Japan; $XVAL_t^{JP}$ is the value of exports to Japan; XP_t is Indonesia's
37 export price; $MVAL_t^{JP}$ is the value of Indonesia's imports from Japan; and XP_t^{JP} is the
38 Japanese export price (proxy for Indonesia's import price from Japan).
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40
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44 ⁸ Previous studies, such as Learner and Stern (1970), suggest that trade *volume* is a more appropriate measure
45 than *value*.

3.3.2. Income

Quarterly real GDP of Japan and Indonesia (y^{JPN} and y^{IND}) are used as proxies for their respective real incomes. As for the world real GDP or income, which is needed for the first two sets of tests, the series is the trade weighted sum of the GDP of Indonesia's six key trading partners.

3.3.3. Terms of trade

The bilateral terms of trade with Japan (p^{JPN}) is constructed as the ratio of Indonesia's export price to the Japan export price (as a proxy for Indonesia's import price from Japan). As for the total terms of trade (p^{World}), the series is the total trade-weighted sum of terms of trade of Indonesia against the country's six key trading partners. The real exchange rate of rupiah against the Japanese yen is computed by multiplying the nominal exchange rate by the relative prices:

$$RER_t^{\text{JP}} = NER_t^{\text{JP}} \times \frac{WPI_t}{WPI_t^{\text{JP}}}, \quad (5)$$

where WPI_t is the domestic wholesale price index of Indonesia and WPI_t^{JP} is the Japanese wholesale price index. An increase in RER_t^{JP} (real exchange rate) or NER_t^{JP} (nominal exchange rate) implies an appreciation in the Indonesian rupiah against the Japanese yen. As for the real effective exchange rate ($REER$), the series is computed as the weighted sum of real exchange of rupiah against seven key trading partners' currencies, viz. the US dollar, Japanese yen, Singapore dollar, British pound sterling, France franc, German DM, and Dutch gulden. The assigned weights to each real exchange rate represent the trade share (imports and exports) of each of these economies in their total trade with Indonesia.

3.3.4. Volatility

The ambiguous results obtained in the empirical literature reviewed in Section 2 may also be partly due to the absence of a uniform definition or means of computing volatility. This is apparent from Table 3. While most studies only provide a single measure of exchange rate volatility, to ensure robustness, we actually construct two measures. We make use of *real* as opposed to *nominal* exchange rates in the computations.⁹

The first index of real exchange rate volatility we construct is a moving average standard deviation ($MASD$) of the growth rate of the exchange rate (ER) initially employed by Kenen and Rodrik (1986).

$$V_t = \left[\frac{1}{m} \sum_{i=1}^m (\ln ER_{t+i-1} - \ln ER_{t+i-2})^2 \right]^{1/2}, \quad (6)$$

where m is the order of the moving average and \ln implies the log form of the series. Our estimations make use of m equal to 4 months for both the $REER$ and bilateral real

⁹ After comparing results from nominal and real exchange rate volatility that are fitted by an ARCH model, Mckenzie and Brooks (1997) conclude, "it would be irrelevant whether the volatility coefficients are estimated from real or nominal exchange rates as the volatility is sourced solely from the nominal exchange rate" (p. 2).

1 Table 3
 2 Exchange rate volatility measures

3 Measures of exchange rate volatility	4 References
5 The average (over thirteen weeks) absolute difference between the 6 previous forward and the current spot rate.	7 Hooper and Kohlhaugen (1978)
8 Gini's mean difference (a non-parametric measure).	9 Rana (1981)
10 Standard deviation of the growth rate of the exchange rate (ER_t) 11 with a moving average transformation (by several authors):	12 IMF (1984), Kenen and Rodrik (1986), 13 Bailey, Tavlas and Ulan (1987), Cushman 14 (1988), Koray and Lastrapes (1989), Las- 15 trapes and Koray (1990), Klein (1990), 16 Bini-Smaghi (1991), Chowdhury (1993), 17 Daly (1998), Wei (1998), Aristotelous 18 (2001)
19 $V_t = \left[\frac{1}{m} \sum_{i=1}^m (\ln ER_{t+i-1} - \ln ER_{t+i-2})^2 \right]^{1/2}$	
20 where m is the order of the moving average.	
21 The variance of the spot exchange rate (ER_t) around its predicted 22 trend that is estimated from $\ln ER_t = \phi_0 + \phi_1 t + \phi_2 t^2 + \varepsilon_t$.	23 Thursby and Thursby (1987)
24 Autoregressive Integrated Moving Average (ARIMA) model.	25 Asseery and Peel (1991)
26 Autoregressive Conditional Heteroskedasticity (ARCH) models.	27 Kroner and Lastrapes (1993), Caporale and 28 Doroodian (1994), Mckenzie and Brooks 29 (1997), Mckenzie (1998), Chou (2000)

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Source: compiled by authors.

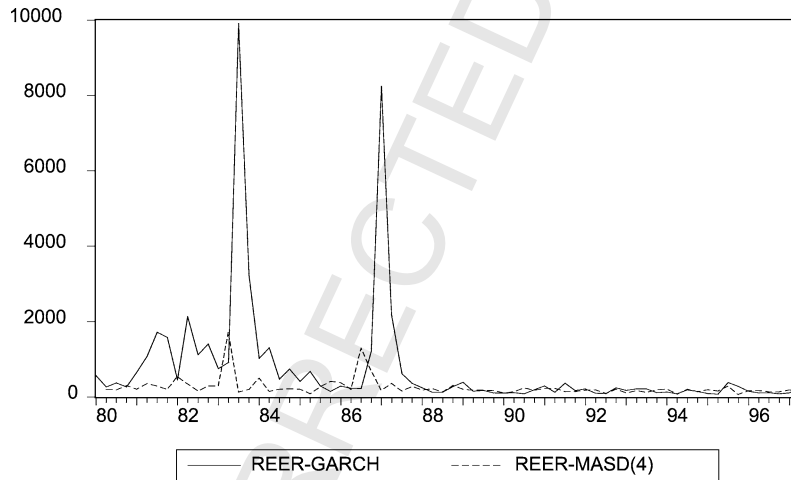


Fig. 4. GARCH(1,1) and MASD volatility of the real effective exchange rate of the rupiah.

exchange rate against the yen.¹⁰ Figs. 4 and 5 show the MASD volatilities $V^{\text{REER-MASD}}$ and $V^{\text{RERJP-MASD}}$. This measurement has an advantage of being able to capture higher

¹⁰ For our empirical tests, we also apply $m = 6$ months and $m = 8$ months. The results are largely consistent with $m = 4$ months.

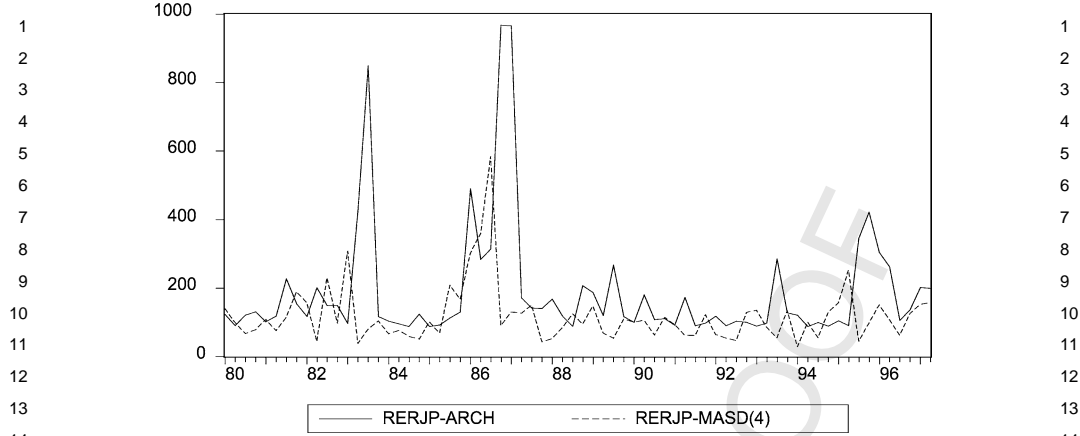


Fig. 5. ARCH(1) and MASD volatility of the real exchange rate of the rupiah against the Japanese yen.

frequency movements in the exchange rate. Several authors have used a moving average transformation to smooth out the series.¹¹

The second measure of real exchange rate volatility we employ is a GARCH specification as follows:

$$\ln REER_t = a_0 + a_1 \ln REER_{t-1} + e_t, \quad \text{where } e_t \sim N(0, h_t), \quad (7a)$$

$$h_t = \alpha + \beta e_{t-1}^2 + \gamma h_{t-1} + u_t. \quad (7b)$$

The conditional variance equation (Eq. (7b)) described above is a function of three terms: (i) the mean, α ; (ii) news about volatility from the previous period, measured as the lag of the squared residual from the mean equation, e_{t-1}^2 (the ARCH term); and (iii) the last period's forecast error variance, h_{t-1} (the GARCH term). We estimated a number of versions of ARCH models. The GARCH (1,1) model generated the best results (significant coefficients for Eq. (7b)) as far as the volatility of the rupiah's REER ($V^{REER-GARCH}$) is concerned, and the ARCH(1) did so for the real exchange rate of the rupiah against the Japanese yen ($V^{RERJPN-ARCH}$) (Table 4, Figs. 4 and 5).¹²

For the single purpose of illustrating the magnitude of the rise in the volatility of rupiah during the post-1997 crisis period, we estimate another GARCH (1,1) conditional variance

¹¹ See, for instance, Koray and Lastrapes (1989), Lastrapes and Koray (1990), Chowdhury (1993), and Daly (1998).

¹² Results of other ARCH specifications are available from the authors upon request. McKenzie (1998) highlights the potential problems involved in ARCH based measures of exchange rate volatility. He opines that the exchange rate volatility generated prior to the end of the sample period incorporates knowledge about the future, as ARCH models are estimated over the entire sample period. To overcome this problem, one would need to re-estimate the ARCH model beginning of each quarter using information that is known to the trader at the point in time. However, if the estimated ARCH/GARCH coefficients are stable over time, one may not need to be concerned about the biasness of the volatility estimates. We find the coefficients for the case of real exchange rate against the Japanese yen and the real effective exchange rate to be stable. It is worth noting that Rahmatsyah et al. (2002) report a broadly similar finding for the case of real exchange rate of the baht against the Japanese yen.

Table 4

GARCH model summary: $h_t = \alpha + \beta e_{t-1}^2 + \gamma h_{t-1} + u_t$

	REER		RERJPN	
	β_1	γ	β_1	γ
GARCH(1,1) ^a	0.9495 (0.2655)	0.2547 (0.1318)		
ARCH(1) ^b			0.5347 (0.2669)	

Notes. The values in the parentheses are standard errors. All coefficients are found to be significant at least at 5% significant level.

^a GARCH (1,1) is the best model for the real effective exchange rate of rupiah.

^b ARCH(1) is the best model for the real exchange rate of rupiah against the yen.

Table 5

Pre- and post-crisis conditional variance (h_t)

Country	Pre-crisis		Post-crisis		Ratio of (2)/(1)
	Mean (1)	Std.dev.	Mean (2)	Std.dev.	
Indonesia	0.000196	0.00011	0.00704	0.00796	35.9
Singapore	0.000062	0.000012	0.000190	0.00019	3.06
Thailand	0.000128	0.000013	0.001736	0.002725	13.56
South Korea	0.000130	0.000083	0.00137	0.00141	10.5

Observation sets:

Indonesia, South Korea and Singapore: pre-crisis: January 1995–June 1997; post-crisis: February 1998–July 2001.

Thailand: pre-crisis: January 1994–June 1997; post-crisis: February 1998–July 2001.

as stated in Eqs. (7a) and (7b) on monthly REER series for the period between January 1994 and July 2001. To further understand the degree of volatility of the rupiah we also test and contrast the rupiah's volatility with those of Singapore dollar, Korean won, and Thai baht. The observation set is divided into the pre-1997 crisis period (January 1994 to June 1997) and the post-1997 crisis period (February 1998 to July 2001). We excluded observations from the most turbulent period of July 1997 to January 1998 so as to avoid overstating the volatility of the regional currencies (and therefore skewing the results).

Table 5 makes clear the severity of the rupiah's volatility compared to other crisis-affected currencies in East Asia. The post-crisis mean conditional variance of rupiah is about thirty five times larger than the pre-crisis average. The next worst case was Thailand, though the jump in its average conditional variance was only about one-third of the rupiah's. The pre-and post-crisis ratio of conditional variances of Singapore dollar and Korean won were in fact less than one-tenth and one-third that of the Indonesian rupiah, respectively. In addition, the average of the conditional variance of the Indonesian rupiah was only 1.5 times of the Thailand's baht and Korean won during the pre-crisis period. However, between February 1998 and July 2001, the post-crisis volatility rate for rupiah was three and six times that of the Thailand's baht and Korean won, respectively. In summary, not only had the rupiah become significantly more volatile in recent years, the magnitude of the volatility rate was extremely high even in comparison to other regional currencies.

4. Test results

Table 6 presents the results for the ADF-unit root tests. All variables are stationary at the first difference ($I(1)$ variables) except the volatility indices which are all $I(0)$. Given the unit-root properties of the variables, we proceed to conduct three sets of Johansen cointegration test procedures on Eqs. (1) and (2).¹³ The test results for the total export and import cases are shown in Tables 7A to 8B. The main result can be summarized as the following set of equations:

$$x_t^{\text{total}} = 134.76 - 8.542y_t^{\text{World}} - 0.315p_t^{\text{World}} - 0.003V_t^{\text{REER-MASD}}, \quad (8)$$

$$x_t^{\text{total}} = 2.044 + 0.344y_t^{\text{World}} - 0.488p_t^{\text{World}} - 150.257V_t^{\text{REER-GARCH}}. \quad (9)$$

Table 6
 Augmented Dickey–fuller test results (all variables are in log-forms, except volatility index)

Country	Series		ADF statistics	Test type	Lag	Order of integration
Indonesia	x^{Total}	Level	-1.381	t and c	4	$I(1)$
		1st difference	-6.229	-	3	
	m^{Total}	Level	-2.756	t and c	4	$I(1)$
		1st difference	-7.784	c	1	
	m^{Capt}	Level	-2.113	t and c	3	$I(1)$
		1st difference	-6.561	-	2	
	M^{Int}	Level	2.160	-	2	$I(1)$
		1st difference	-8.908	c	1	
	x^{JP}	Level	-2.018	c	2	$I(1)$
		1st difference	-7.551	c	2	
	m^{JP}	Level	-2.377	t and c	4	$I(1)$
		1st difference	-5.204	-	3	
	tot^{World}	Level	-1.833	c	6	$I(1)$
		1st difference	-7.868	-	1	
tot^{JP}	Level	-1.146	-	1	$I(1)$	
	1st difference	-6.814	-	1		
y^{IND}	Level	-1.293	t and c	5	$I(1)$	
	1st difference	-4.604	t and c	4		
	$V^{\text{REER-MASD}}$	Level	-4.171	t and c	2	$I(0)$
	$V^{\text{REER-GARCH}}$	Level	-4.436	t and c	2	$I(0)$
	$V^{\text{JP-MASD}}$	Level	-3.874	c	1	$I(0)$
	$V^{\text{JP-ARCH}}$	Level	-4.231	c	1	$I(0)$
World	y^{World}	Level	-2.043	c	4	$I(1)$
		1st difference	-3.246	-	3	
Japan	y^{JP}	Level	-2.077	c	1	$I(1)$
		1st difference	-3.789	c	1	

Notes. ADF statistics indicates results at 5% significance level. t = trend and c = constant.

¹³ Engle and Granger (2000, p. 14) state that inclusion of stationary variable in the cointegrating relationship should not affect the remaining coefficients (assuming that it is not the dependent variable). It also ought not to affect the asymptotic critical values of the test statistics.

1 Table 7
 2 Cointegration test results for total exports
 3 Period: 1984:1–1997:2 (lags = 1)

4 Eigenvalue	Likelihood ratio (LR)	Critical value	No. of cointegrating equation(s)
5			
6 A. 5 percent critical value ^a			
7 0.366	52.96	47.21	None
8 0.274	28.81	29.68	At most 1
9 0.181	11.86	15.41	At most 2
0.024	1.262	3.76	At most 3
10			
11 B. 1 percent critical value. ^b			
12 0.452	59.620	54.46	None
13 0.265	27.728	35.65	At most 1
14 0.178	11.441	20.04	At most 2
0.019	1.042	6.65	At most 3

15 Notes. LR indicates 1 cointegrating equation at 1% significance level. Chi-square critical values: at 1 percent = 6.6349; at 5 percent = 3.8415; at 10 percent = 2.7055.

16 ^a $x^{Total} = 134.76 - 8.542y^{World} - 0.315_{tot}^{World} - 0.003V^{REER-MASD}$.

17 standard error: (2.946) (0.323) (0.0009)

18 chi-square: (8.406) (0.951) (11.099)

19 ^b $x^{Total} = 2.044 + 0.344y^{World} - 0.488_{tot}^{World} - 150.257V^{REER-GARCH}$.

20 standard error: (5.423) (0.674) (89.30)

21 chi-square: (0.004) (0.519) (2.832)

26 Table 8
 27 Cointegration test results for total imports
 28 Period: 1980:1–1997:2 (lags = 6)

29 Eigenvalue	Likelihood ratio (LR)	1 percent critical value	No. of cointegrating equation(s)
30			
31 A ^a			
32 0.500	72.859	54.46	None
33 0.283	29.839	35.65	At most 1
34 0.125	9.218	20.04	At most 2
0.015	0.906	6.65	At most 3
35			
36 B ^b			
37 0.490	72.273	54.46	None
38 0.252	30.495	35.65	At most 1
0.164	12.457	20.04	At most 2
0.022	1.361	6.65	At most 3

39 Notes. LR indicates 1 cointegrating equation at 1% significance level. Chi-square critical values: at 1 percent = 6.6349; at 5 percent = 3.8415; at 10 percent = 2.7055.

40 ^a $m^{Total} = -11.293 + 1.218y^{IND} + 0.568_{tot}^{World} - 0.0002V^{REER-MASD}$.

41 standard error: (0.147) (0.093) (0.0004)

42 chi-square: (68.65) (37.29) (0.25)

43 ^b $m^{Total} = -11.742 + 1.275y^{IND} + 0.514_{tot}^{World} + 4.283V^{REER-GARCH}$.

44 standard error: (0.124) (0.086) (5.714)

45 chi-square: (105.7) (35.72) (0.562)

$$1 \quad \text{Imports: } m_t^{\text{total}} = -11.293 + 1.218y_t^{\text{World}} + 0.568p_t^{\text{World}} - 0.0002V_t^{\text{REER-MASD}}, \quad (10) \quad 1$$

$$2 \quad m_t^{\text{total}} = -11.742 + 1.275y_t^{\text{World}} + 0.514p_t^{\text{World}} + 4.283V_t^{\text{REER-GARCH}}. \quad (11) \quad 2$$

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One cointegration relationship is found in all regressions at the 1 percent significance level, except for one of the export cases at the 5 percent significance level. With regard to the export functions, we find the world income variable has either played an altogether insignificant role or has a theoretically inconsistent sign (Tables 7A and 7B). Similarly, we find the terms of trade or price variable to be statistically insignificant.¹⁴ However, the real effective exchange rate volatility indices are significant and negative at least 1 percent and 10 percent significance level for $V^{\text{REER-MASD}}$ and $V^{\text{REER-GARCH}}$, respectively.

With regard to the import functions, we find the income and price proxies are generally significant (at 1 percent level) with theoretically consistent signs. However, the exchange rate volatility indices turn out to be statistically insignificant. To further evaluate the role of exchange rate volatility on Indonesian imports, we sub-divide Indonesia's imports into its two main components, viz. *intermediate and capital imports*. The test results are detailed in Tables 9A to 10B. A summary of the results is offered using the following equations:

Capital imports:

$$20 \quad m_t^{\text{Capt}} = -32.735 + 3.337y_t^{\text{IND}} + 0.927p_t^{\text{World}} - 0.008V_t^{\text{REER-MASD}}, \quad (12) \quad 20$$

$$21 \quad m_t^{\text{Capt}} = -7.674 + 0.956y_t^{\text{IND}} + 1.045p_t^{\text{World}} - 113.95V_t^{\text{REER-GARCH}}. \quad (13) \quad 21$$

Intermediate imports:

$$22 \quad m_t^{\text{Int}} = -16.449 + 1.758y_t^{\text{IND}} + 1.262p_t^{\text{World}} - 0.002V_t^{\text{REER-MASD}}, \quad (14) \quad 22$$

$$23 \quad m_t^{\text{Int}} = -16.038 + 1.739y_t^{\text{IND}} + 1.169p_t^{\text{World}} - 7.114V_t^{\text{REER-GARCH}}. \quad (15) \quad 23$$

As for the cases of capital imports, one cointegration equation is found to exist at the 1 percent and 5 percent significance level. For both intermediate import equations, one cointegration equation is found at 1 percent level. The coefficients for both the income and competitiveness proxies are significant at the 1 percent level and are theoretically consistent. The income variable has also contributed positively and significantly, except for the case of capital imports (Table 9B). We find relatively conclusive results for the real exchange rate volatility indices. Specifically, the coefficient estimates for both the real exchange rate volatility indices are statistically significant and negative in the case of capital imports at the 1 percent significance level for $V^{\text{REER-MASD}}$ and at the 5 percent significance level for $V^{\text{REER-GARCH}}$. The same can be said for intermediate capital imports when the Moving Average Standard Deviation volatility index is used but not when GARCH(1,1) is used.

¹⁴ The poor results for income and terms of trade variables may be due to the quality of proxies that we constructed. However with no official data available for these two series, we have no alternatives but to construct the proxies.

1 Table 9
 2 Cointegration test results for total capital imports
 3 Period: 1980:1–1997:2

4 Eigenvalue	Likelihood ratio (LR)	Critical value	No. of cointegrating equation(s)
5			
6 A. lags = 8, 1% critical value ^a			
7 0.697	109.08	54.46	None
8 0.227	30.37	35.65	At most 1
9 0.195	15.34	20.04	At most 2
10 0.038	2.34	6.65	At most 3
11			
12 B. lags = 4, 5% critical value ^b			
13 0.333	49.84	47.21	None
14 0.180	22.74	29.68	At most 1
15 0.135	10.04	15.41	At most 2
16 0.012	0.78	3.76	At most 3

17 Notes. LR indicates 1 cointegrating equation at 1% significance level. Chi-square critical values: at 1 percent =
 18 6.6349; at 5 percent = 3.8415; at 10 percent = 2.7055.

19 ^a $m^{Capt} = -32.735 + 3.337y^{IND} + 0.927tot^{World} - 0.008V^{REER-MASD}$.
 20 standard error: (0.465) (0.322) (0.002)
 21 chi-square: (51.49) (8.29) (16.00)

22 ^b $m^{Capt} = -7.674 + 0.956y^{IND} + 1.045tot^{World} - 113.95V^{REER-GARCH}$.
 23 standard error: (0.997) (0.548) (53.96)
 24 chi-square: (0.927) (3.636) (4.46)

25 Table 10
 26 Cointegration test results for total intermediate imports
 27 Period: 1980:1–1997:2 (lags = 6)

29 Eigenvalue	Likelihood ratio (LR)	1 percent critical value	No. of cointegrating equation(s)
30			
31 A ^a			
32 0.458	77.28	54.46	None
33 0.289	35.34	35.65	At most 1
34 0.176	14.19	20.04	At most 2
35 0.035	2.22	6.65	At most 3
36			
37 B ^b			
38 0.437	66.96	54.46	None
39 0.272	31.38	35.65	At most 1
40 0.147	11.72	20.04	At most 2
41 0.029	1.85	6.65	At most 3

42 Notes. LR indicates 1 cointegrating equation at 1% significance level. Chi-square critical values: at 1 percent =
 43 6.6349; at 5 percent = 3.8415; at 10 percent = 2.7055.

44 ^a $m^{Int} = -16.449 + 1.758y^{IND} + 1.262tot^{World} - 0.002V^{REER-MASD}$.
 45 standard error: (0.218) (0.175) (0.0007)
 chi-square: (65.04) (52.02) (8.16)

^b $m^{Int} = -16.038 + 1.739y^{IND} + 1.169tot^{World} - 7.114V^{REER-GARCH}$.
 standard error: (0.215) (0.151) (8.453)
 chi-square: (65.42) (59.94) (0.71)

4.1. Indonesia–Japan bilateral trade

We conduct a last battery of tests on the Indonesia’s exports to and imports from Japan at a bilateral level. Japan has been Indonesia’s largest market for Indonesian exports and its largest source of import since 1980. Out of Indonesia’s total non-oil manufacturing trade (exports plus imports), the average share of the country’s trade with Japan 1980–1997 is in the range of 35 percent to 40 percent. Therefore, it is important to understand how exchange rate volatility may impact Indonesia’s trade performance vis-à-vis the Japanese market. The test results may be described in the following set of equations and details are provided in Tables 11A to 12B.

$$\text{Exports: } x_t^{\text{JPN}} = -2.106 + 0.654y_t^{\text{JPN}} - 0.386p_t^{\text{JPN}} - 0.0009V_t^{\text{RERJPN-MASD}}, \quad (16)$$

$$x_t^{\text{JPN}} = -0.369 + 0.534y_t^{\text{JPN}} - 0.429p_t^{\text{JPN}} - 29.62V_t^{\text{RERJPN-ARCH}}. \quad (17)$$

$$\text{Imports: } m_t^{\text{JPN}} = -1.196 + 0.439y_t^{\text{IND}} + 0.201p_t^{\text{JPN}} - 0.0004V_t^{\text{RERJPN-MASD}}, \quad (18)$$

$$m_t^{\text{JPN}} = -1.080 + 0.428y_t^{\text{IND}} + 0.211p_t^{\text{JPN}} - 25.89V_t^{\text{RERJPN-ARCH}}. \quad (19)$$

One cointegration equation exists in both the export and import regressions at the 1 percent and 5 percent level of significance, respectively. The estimated coefficients for the price and income terms are significant at the 1 percent level with theoretically consistent signs. Results for the volatility indices indicate that the exchange rate volatility negatively impacts both Indonesia’s trade flows to Japan (all significant at the 1 percent critical level).

Table 11
 Cointegration test results for total exports to Japan
 Period: 1984:1–1997:2 (lags = 1)

	Eigenvalue	Likelihood ratio (LR)	1 percent critical value	No. of cointegrating equation(s)
A ^a	0.499	63.85	54.46	None
	0.251	27.86	35.65	At most 1
	0.131	12.81	20.04	At most 2
	0.101	5.53	6.65	At most 3
B ^b	0.558	70.97	54.46	None
	0.252	28.48	35.65	At most 1
	0.136	13.41	20.04	At most 2
	0.106	5.83	6.65	At most 3

Notes. LR indicates 1 cointegrating equation at 1% significance level. Chi-square critical values: at 1 percent = 6.6349; at 5 percent = 3.8415; at 10 percent = 2.7055.

$$^a x^{\text{JP}} = -2.106 + 0.654y^{\text{JP}} - 0.386p^{\text{JP}} - 0.0009V^{\text{JP-MASD}},$$

$$\text{standard error: } (0.118) \quad (0.046) \quad (0.0001)$$

$$\text{chi-square: } (30.70) \quad (70.40) \quad (81.00)$$

$$^b x^{\text{JP}} = -0.369 + 0.534y^{\text{JP}} - 0.429p^{\text{JP}} - 29.62V^{\text{JP-ARCH}},$$

$$\text{standard error: } (0.113) \quad (0.044) \quad (4.374)$$

$$\text{chi-square: } (22.35) \quad (95.06) \quad (45.85)$$

1 Table 12
2 Cointegration test results for total imports from Japan
3 Period: 1979:1–1997:2 (lags = 1)

	Eigenvalue	Likelihood ratio (LR)	5 percent critical value	No. of cointegrating equation(s)
A ^a	0.283	48.53	47.21	None
	0.208	24.21	29.68	At most 1
	0.093	7.17	15.41	At most 2
	0.0004	0.03	3.76	At most 3
B ^b	0.339	52.54	47.21	None
	0.185	22.27	29.68	At most 1
	0.095	7.36	15.41	At most 2
	0.0008	0.06	3.76	At most 3

13 Notes. LR indicates 1 cointegrating equation at 1% significance level. Chi-square critical values: at 1 percent =
14 6.6349; at 5 percent = 3.8415; at 10 percent = 2.7055.

15 ^a $m^{JP} = -1.196 + 0.439y^{IND} + 0.201tor^{JP} - 0.0004V^{JP-MASD}$.
16 standard error: (0.065) (0.045) (0.0001)
17 chi-square: (45.59) (19.95) (9.00)

18 ^b $m^{JP} = -1.080 + 0.428y^{IND} + 0.211tor^{JP} - 25.899V^{JP-ARCH}$.
19 standard error: (0.066) (0.045) (6.223)
20 chi-square: (42.09) (21.99) (17.32)

21 5. Concluding remarks

22 While there are a host of factors that could lead a crisis-induced devaluation (i.e.,
23 a devaluation following a currency crisis) to be contractionary, a necessary condition for
24 economic recovery is that exports are boosted. Exports are supposed to be the engine of
25 growth following such an expenditure switching policy. Nonetheless, despite the dramatic
26 decline in the nominal value of the rupiah since mid 1997 (which has in turn been translated
27 into a real devaluation), exports *did not* show a stable and strong pick up even four years
28 after the break of the crisis; if anything, just the reverse happened. Indeed, the latest
29 developments and outlook for Indonesia's external trade sector for 2002 continue to remain
30 quite bleak (Siregar, 2001).

31 The question we have explored in this paper is whether exchange rate volatility has
32 had any detrimental impact on trade flows in Indonesia during the pre-crisis period. Our
33 observation period has spanned Q2: 1980 to Q2: 1997. We have intentionally excluded
34 the crisis period itself in order to circumvent problems related to structural breaks in the
35 trade series which may be associated with various non-economic factors, like political
36 uncertainty.¹⁵

37 Table 13 summarizes our regression results. Out of twelve regressions undertaken in
38 this paper, nine cases indicate that exchange rate volatility adversely affected exports and
39 imports performance of Indonesia during the pre-crisis period. Extrapolating these results

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41
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43 ¹⁵ Indeed, the rupiah's post 1997 volatility may have been a reflection of the underlying social and political
44 instability in the country which in turn could have caused foreign buyers to shift their orders to other countries
45 (Rosner, 2000).

Cases	VMASD	VGARCH(1,1)
A. With the world markets		
Total exports	Negative Significant at 1%	Negative Significant at 10%
Total imports	Negative Not significant	Positive Not significant
Capital imports	Negative Significant at 1%	Negative Significant at 5%
Intermediate imports	Negative Significant at 1%	Negative Not significant
B. With the Japanese market		
Exports to Japan	Negative Significant at 1%	Negative Significant at 1%
Imports from Japan	Negative Significant at 1%	Negative Significant at 1%

forward, the rise in exchange rate volatilities should have played a critical role in explaining the poor performance of the trade sector in recent years. The adverse impact of exchange rate volatility on trade and the real sector may in part be the reason for the supposed “fear of floating” that has seemed to characterize many emerging economies.¹⁶ Recent financial crises involving emerging economies have called into question the wisdom of them adopting pegged exchange rates (be it “hard” or “soft”) and has strengthened the appeal of allowing for greater exchange rate flexibility. However, it is easy to overlook that flexible exchange rates bring with them their own problems. This surely has implications for the perennial issue of appropriate choice of exchange rate regime.

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¹⁶ This term was popularized by Calvo and Reinhart (2001). Other reasons for this phenomenon could include concerns about liability dollarization as well as possible inflationary effects of exchange rate fluctuations. Also see Rajan (2002).

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