

Occasional Papers No. 4

**THE IMPACT OF EXCHANGE RATE CHANGES
IN KEY CURRENCIES ON TRADE**

Richard P. Mattione



The South East Asian Central Banks (SEACEN)
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Published by The South East Asian Central Banks (SEACEN)
Research and Training Centre
Lorong Universiti A, 59100 Kuala Lumpur, Malaysia.
Tel No: 03-7568622/7568587 Fax No: 603-7574616
Telex: MA 30201 Cable: SEACEN KUALA LUMPUR

ISBN: 983-9553-08-9

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FOREWORD

Exchange rate changes in key currencies is important to both sides of a transaction in foreign exchange: the party who has the local currency and the party who has the foreign currency. This is because both parties use their respective currencies either to buy or pay for goods and services, or as an earning asset which can be switched around depending on its rate of return, or a store of wealth whose value depends among others on their going crossrate in the international marketplace.

Accordingly, the matter is important across developing as well as developed countries. For developing countries, both the rural farmers and the urban factories invariably depend on imported goods or services to some extent or another. For those that export among them and do so on borrowed funds from overseas, their survival in the business may well depend on exchange rate changes with certain predictable fluctuations which had been taken into account in their prior efforts at business planning. And for governments in developing countries which borrow, exchange rate changes can also spell either a shorter or longer political life depending on whether incremental taxation to service the sovereign debt can be much longer tolerated by the people they serve or not.

Indeed, exchange rate movements, especially if they involve the major currencies of the world and if characterized with high volatility, could exert tremendous impact on the domestic and external economic activities of open economies. The article contained in this *Occasional Papers No.4* deals on one field which is most affected by fluctuations in exchange rates – international trade. It was written by Dr. Richard P. Mattione, Vice President of Morgan Guaranty Trust Co., Tokyo office, in his capacity as a resource person in the SEACEN Seminar on The Impact of Exchange Rate Changes in Key Currencies on the Balance of Payments, held on 22-24 October 1987 at Denpasar, Bali, Indonesia. Dr. Mattione graduated from Harvard University, with a Ph.D. in Economics. He worked for three years at the Brookings Institution in Washington, D.C. before joining Morgan Guaranty. His main responsibility at Morgan Guaranty is to cover Japan's economy and financial markets. He is the co-author of two books on the debt crisis, and the author of one book on OPEC's investments.

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The determination of appropriate exchange rates has been the focal point of countless discussions in the years since World War II. The topic acquired new urgency after the dismantling of the Bretton Woods system of fixed exchange rates. Those interested most in the exchange rates of industrial countries have had one agenda, including problems such as excessive volatility, while those interested in development have argued at length about the role of exchange rate policy. Industrial country policymakers have often ignored the latter question during their summits, but developing countries have necessarily focused on both.

Clearly, neither fixed nor freely floating exchange rate systems can eliminate all the risks of exchange rates for global commerce and finance. Those who advocated a floating-rate system have been surprised by the sharp fluctuations that have occurred, particularly in the 1980s. In recent years, many have come to advocate schemes – target zones, for example – that would reduce volatility (see Williamson). One such agreement already exists, as seven European nations have joined to implement the European Monetary System (EMS). One might also argue that officials of the Group of Seven (G-7) nations have implicitly approved target zones for their currencies in the Louvre accord of February 1987.

As of now, however, it appears that fixed exchange rate systems do not work very well and that target zones are necessarily so wide and flexible as to be no target at all. Attempts to set up fixed rate systems always founder on the need for price adjustments, a problem which even the EMS has experienced. More often, no system is established because it proves too difficult to agree on an initial set of rates, whether one is interested in fixed exchange rate systems or target zones; most countries remain enamored of exchange rates that guarantee a payments surplus (either on trade or current account), but a global surplus is impossible.

Floating rates might work well if nations were more willing to coordinate fiscal and monetary policies, but countries have yet to accept such constraints on their sovereignty. Thus, exchange rate problems will remain, both for key industrial country currencies and for the currencies of developing nations. Forecasting the influence of changes in exchange rates remains an art, not a science, but clearly the effects are powerful.

The Key Currencies

Despite the fact that seven industrial countries attend economic summits and discuss exchange rate questions, three currencies garner

virtually all the attention: the U. S. dollar, the Japanese yen, and the German mark. The narrower focus is easy to justify; the interrelationship of the Canadian and American economies constrains the freedom of the Canadian dollar, while the EMS agreement forces the French franc and Italian lira to follow the mark. The pound sterling is a potential free agent, but British policymakers have recently been acting as if an implicit peg exists against the mark.

Even among these three countries, currency values have moved sharply (see Chart 1). The dollar, overvalued by the end of the 1960s, fell sharply once the constraints of the Bretton Woods system were removed. Japan and, to a lesser extent, West Germany were reluctant to let their currencies appreciate, but President Nixon forced the issue in 1971 by suspending gold convertibility and briefly imposing a surcharge on imports. During the 1970s, there was one period of renewed dollar strength after the first oil shock, but strong growth financed by expansionary monetary policy eventually forced a new fall in the dollar. The second oil shock coincided with a new rise in the dollar, but even more important was a switch to tighter Federal Reserve policy that took interest rates over 20 per cent in 1980 in an attempt to wring out U. S. inflation. The attempt also triggered a global recession that exposed the excesses that had occurred in bank lending to developing countries, and drew investors to dollar assets as a safe haven. Loose fiscal policy, once the recession ended in 1982, sparked a spending boom in the United States (both consumption and investment spending) that coincided with continued tightness in monetary policy. Interest rates and the dollar rose, and the United States was forced to turn to global capital markets to fund its deficit.

Academics had no doubt that the strong dollar of the early 1980s would be damaging to U.S. trade. However, the Reagan administration (particularly then Treasury Secretary Donald Regan) sold itself on the notion that a strong dollar was synonymous with a strong United States. Only when James Baker took over at the Treasury Department did a more realistic view come to rule. The Plaza Agreement of September 1985 marked the first step. Participants at that meeting apparently hoped that exchange rates of 200 yen or 2.50 Deutsche marks per dollar would serve to correct trade balances. Now, two years later, we are far from the earlier target, operating within an implicit band centred on 145 yen or 1.85 marks per dollar. Yet, the dollar depreciation of the last two years has had modest effects on trade and current account balances, which in West Germany and Japan only recently have begun to contract, while the United States trade deficit seems likely to hit a new record this year (see Chart 2).

One reason why adjustment has been slow is that the dollar's earlier strength was so disproportionate. The Reagan administration expected a strong dollar to strengthen U. S. competitiveness by weeding

Chart 1
Spot Exchange Rate

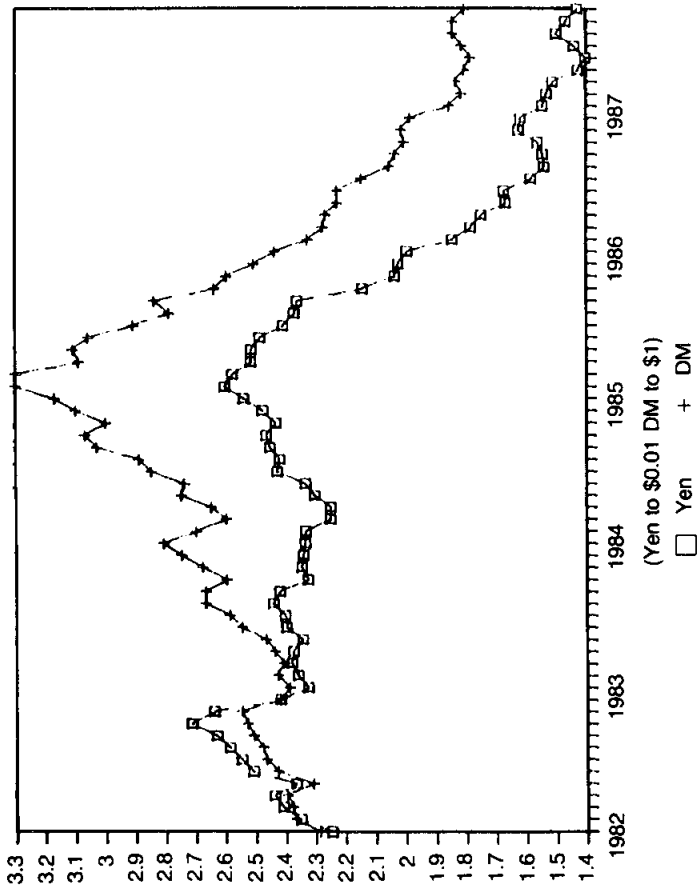
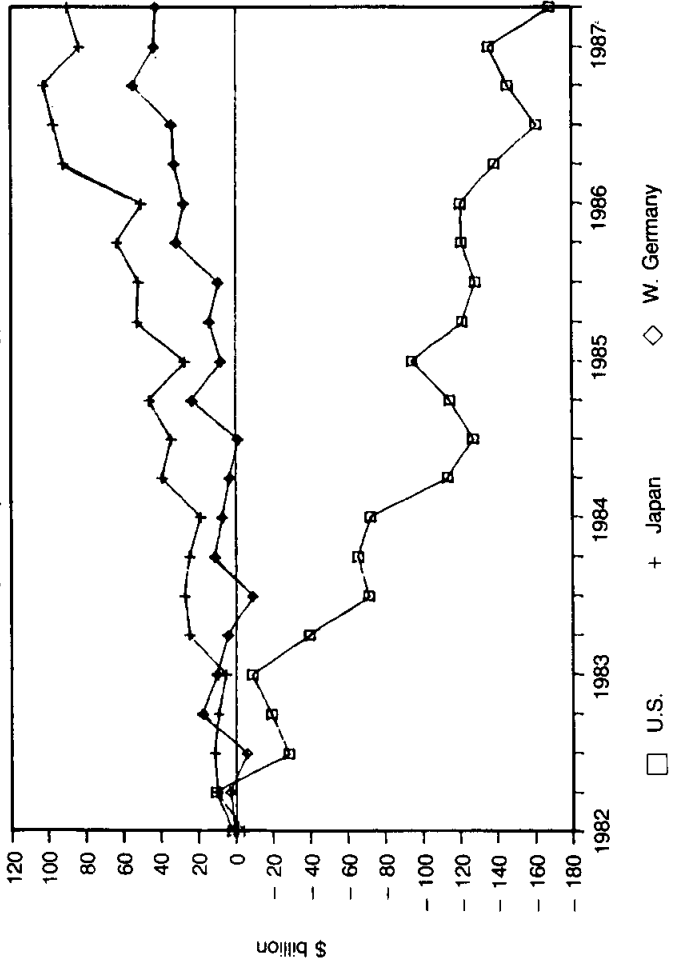


Chart 2
Current Account Balance
 (U.S., Japan, W. Germany)



out the weakest firms and forcing management to pay more attention to costs. Unfortunately, a strong dollar also eliminated some not-so-weak U.S. firms that were unable to meet the competition abroad or at home. The value of U.S. exports stayed fairly steady from 1982 to 1986 despite the dollar's rise (though they should have risen a cumulative 30 per cent to 40 per cent during those four years, based on earlier trends) and have recovered in 1987, growing by 10 per cent through August compared to the same period last year (see Table 1). Imports rose 50 per cent from 1982 to 1986, however, even though prices fell for many commodities, and have grown another 9 per cent so far in 1987. Some observers have taken comfort in the fact that most of the growth in export values this year also represents growth in volumes, while import values have risen less than import prices. But that provides little comfort from a financing point of view, as the growth in imports unfortunately has occurred from a very high base, allowing the deficit to expand further in 1987.

Table 1
U. S. TRADE BALANCES BY COMMODITY
(Billions of Dollars; Millions of Barrels Per Day)

	1985	1986	January – August*		
			1987	1986	% Change
Balance	-134	-156	-114	-109	5.0
Exports	219	227	161	143	13.2
Imports	352	383	276	251	9.7
Manufactures	-114	-145	-101	-97	4.6
Exports	146	149	110	98	12.5
Imports	259	294	211	195	8.5
Petroleum					
Value	-52	-38	-29	-26	10.5
Volume (mbd)	5.2	6.6	6.6	6.3	4.7

* The U.S. Department of Commerce has not published revised figures for U.S. exports to Canada in 1986 on a monthly basis, thus unrevised export data were used. Total exports and manufactured exports in the first eight months of 1986 would otherwise be higher by about \$6 billion, and the total and manufactures balances would improve by the same amount.

On a geographical basis, the U. S. deficits with Canada and Western Europe have narrowed in the first eight months of 1987; the deficit with Japan has also narrowed if one excludes gold shipped via the United States (see Table 2). The U. S. deficit has widened considerably in recent months, however, causing some doubts about the relevance of the earlier data. And the deficit with developing nations, especially Taiwan and South Korea, has expanded rapidly (at least until strikes temporarily slowed South Korea's export drive). Finally, the wide gap between exports and imports of manufactures remains distressing, although the falling dollar seems to have blunted the trend for the United States to become a net importer of foods.

Table 2
U. S. TRADE BALANCES BY REGION
(Billions of dollars)

	January – August*				
	1985	1986	1987	1986	% Change
Total	-134	-156	-114	-109	5.0
Developed nations	-98	-113	-66	-78	-14.9
Japan	-50	-59	-40	-39	2.0
Canada	-22	-23	-7	-16	-55.8
Western Europe	-27	-33	-20	-24	-13.3
Developing nations	-51	-54	-45	-36	25.1
Hong Kong	-6	-6	-4	-4	7.5
Taiwan	-13	-16	-13	-10	28.4
South Korea	-5	-7	-7	-5	33.9

* The U.S. Department of Commerce has not published revised figures for U. S. exports to Canada in 1986 on a monthly basis, thus unrevised export data were used. The balances with Canada, developed nations, and the world ("Total") are thus understated by about \$6 billion for the first eight months of 1986.

Japan's imports have risen rapidly within the last few months (see Table 3). The value of commodity imports, oil or otherwise, has increased mostly because prices have recovered from the lows attained in the third quarter of 1987. The rise in manufactures imports, however, stems from a rapid increase in volumes (about 25 per cent on a year-over-year basis in recent months) that began only in May of this year. This leads to the suspicion that Japanese industry is in general quite competitive if the dollar is stronger than 150 yen per dollar, since manufactures imports took off only after that level was convincingly breached. (This does not

mean that 150 yen per dollar is the correct exchange rate, only that stronger rates for the dollar are clearly inappropriate.) The recent trends in imports have stemmed Japan's surplus only modestly, however, since exporters have been able to raise dollar prices.

Table 3
JAPANESE TRADE BALANCES (CUSTOMS CLEARANCE BASIS)
(Billions of Dollars unless otherwise indicated)

	January – September				
	1985	1986	1987	1986	% Change
Trade balance	46	83	60	59	1.4
United States	39	51	38	37	3.4
European Community	11	17	15	13	15.1
South East Asia	3	13	11	9	28.3
Exports	176	209	166	153	8.3
United States	65	80	61	59	3.2
Imports	130	126	107	95	12.7
United States	26	29	23	22	3.0
Imports by commodity:					
Petroleum*	43	26	21	21	3.2
Manufactures	38	46	44	33	33.3
Exports by commodity:					
Machinery	126	155	124	113	9.3

* Includes crude oil, petroleum products, and LPG.

The geographical pattern of Japan's surplus has also changed in interesting ways. In August 1987, the surplus with the United States fell noticeably below year-earlier levels for the first time in some years (there was an infinitesimal decline in March), but rebounded in September. The surpluses with South-east Asian nations and with Europe had also continued to rise until quite recently and, in the European case, threaten to rise anew. Those increases could have occurred with little change in volumes; much of the manufactures trade would have been priced in marks, yen, and other currencies that had risen against the dollar, while the prices of Asia's commodity exports have also gone up in dollar terms. Some of the rise also stems from the triangular pattern of trade. Japanese industry has responded to the strong yen by shipping parts to plants in South-east Asia, where the items are assembled and then sold in the United States. This, in essence, replaces a direct bilateral imbalance between Japan and the United States with two new imba-

lances: a Japanese surplus with South-east Asia and a United States deficit with South-east Asia.

The changing pattern of U.S. and Japanese trade imbalances are symptomatic of the broad changes now occurring in global trade patterns. Exporters in Japan and (to a lesser extent) Germany have been able to cut prices in their own currency for their products, and as a result have held on to market share fairly well. This scarcely invalidates the theory of exchange rates, but only shows that one must account for all items relevant to price calculations. The dollar was so strong earlier in the 1980s that many exporters still find it profitable to service the U.S. market, even at lower margins. As a related matter, some of the most competitive producers have begun to redirect their attention to markets outside of North America. Both Japanese and German producers have found profitable opportunities in Europe, while a few Asian producers have discovered new markets in both Japan and Europe. This suggests that the gradual solution of the dollar problem will bring to the surface some of the misalignments across non-dollar currencies that most countries have been able to ignore. Although cross-currency misalignments are rarely as severe as the dollar's overpricing in early 1985, they may prove as difficult to resolve.

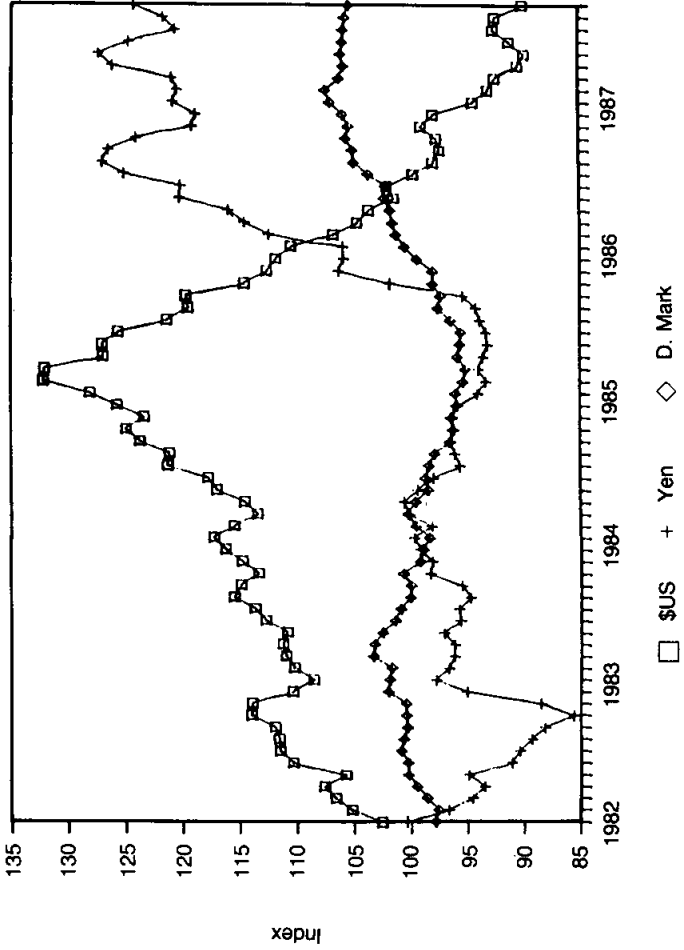
The use of real exchange rate indices, as opposed to spot exchange rates, helps clarify the picture of whose exchange rates have changed and by how much. Of course, there are many ways to calculate such indices (see Morgan Guaranty Trust, 1986). The Morgan Guaranty indices focus on trade in manufactures, on the grounds that exchange rates do not play a major role in commodity trade (obviously they play some role: there is an exchange rate at which American copper production could displace Chilean, and in 1986 the United States saw brief periods where its normal surplus in agricultural trade disappeared). These indices conform broadly to the trends in spot rates (see Chart 3). The dollar has indeed fallen sharply since the Plaza Agreement of September 1985 – some 19.2 per cent. The yen and the mark have risen by 27.2 per cent and 11.0 per cent, respectively, with the differences between the mark and the yen reflecting the weighting of bilateral trade. For example, the mark has appreciated considerably less than the yen on an effective basis because more of West Germany's trade is with European nations against whose currencies the mark has appreciated very little. The French franc, the pound, the lira, and the Canadian dollar are up by less than 10 per cent during this time. The performance seems to parallel a country's balance of payments position -- the larger the surplus, the greater the appreciation. Japan's performance stands out most, for its surplus remains large despite a 27 per cent appreciation.

Exchange Rates in the Developing Countries

Two concerns predominate for developing countries when analyzing exchange rate policies. Without a doubt, exchange rates

Chart 3

Effective Exchange Rate



powerfully influence the depth and speed of economic expansion, so countries must follow an "appropriate" policy (see Balassa, 1987). But as rising incomes carry developing countries into the ranks of developed countries, they will face new constraints on their exchange rate policies.

Asia's middle income LDCs seemed to have learned more quickly and thoroughly than other developing nations the need for appropriate exchange rates. By now, numerous studies have argued that exchange rate policies were perhaps the key factor separating developing countries with debt problems from those which sailed through the debt crisis (see Balassa; Enders and Mattione; and Sachs). Latin America pursued policies of import substitution that supposedly made exchange rates irrelevant, yet got into problems. Too high an exchange rate discouraged the transition from commodities to manufacturing in general, despite high tariffs designed to protect domestic firms. Meanwhile, the tariff barriers that "necessarily" accompanied inappropriate exchange rates led to inefficient patterns of capital-intensive growth that did not contribute to employment growth. Last, but not least, inappropriate exchange rates encouraged capital flight before the inevitable correction.

The shift from commodity to manufactures exports has gradually become one of the measures of development success. By this criterion many Asian LDCs have done well. Those shares have been rising for most of the region's countries during the 1980s (see Table 4), and have in general been higher than in Latin America LDCs (see Morgan Guaranty Trust, 1985). Of course, the low relative price for commodities has automatically lifted the share of manufactures in exports in recent

Table 4
COMMODITY COMPOSITION OF EXPORTS
(Share of Total, in Per cent)

	1980		1986**	
	Fuels	Manufactures	Fuels	Manufactures
Burma	1*	4*	n.a.	n.a.
Indonesia	80	5	61	6
Malaysia	25	28	31	32
Nepal	0	27	0	44
Philippines	1	24	0	36
Singapore	25	48	21	60
Sri Lanka	15	19	n.a.	n.a.
Thailand	1	35	1	44

* For Burma, data are from 1976.

** 1985 data for Malaysia, Nepal, and the Philippines. For Nepal, the years are fiscal years.

years. The orientation of exports to manufactures – accompanied by low exchange rates – has been correlated strongly with high growth in the 1980s. Four nations – South Korea, Taiwan, Singapore, and Hong Kong – best exemplify Asia's successes. One might argue that all four are special cases, for they had no natural resources on which to base development strategies. Yet, a number of "natural" commodity exporters have stayed poor simply because they were unwilling to pursue the sort of policies that would allow them to break their commodity dependence.

Nonetheless, one must be careful about putting too much weight on any single index, measure, or strategy for competitiveness. It is not wise to pursue a policy of "cheap" exchange rates, nor to pursue a policy of pushing out exports of manufactures. Maximizing a nation's welfare, perhaps as measured by incomes, while minimizing fluctuations in economic activity is a more suitable (albeit vaguely-defined) goal. Balance of payments considerations and the availability of finance will pose important constraints for policy. And even as some countries in Asia enter world markets at the lower end of the spectrum, other should shift to higher-quality products.

There are several other cautions. Several countries that would seem to be natural commodity exporters had taxed the agricultural sector heavily under the mistaken notion that commodities did not matter (Argentina's export taxes on grains offer a good example). Such policies simply serve to price the country out of markets for both commodities and manufactures when domestic manufacturing is protected from global competition. Some countries prematurely decided to advance from low-wage, labour-intensive industries to capital-intensive sectors. And some developing nations (South Korea and Taiwan are the best examples today) have pursued low exchange-rates, low-wage development without freeing up imports. That only invites complaints from trading partners without improving national welfare (see Morgan Guaranty Trust, 1987a).

Adjustment and the Prospects for South-east Asia

Experience has taught that large swings are often partially undone, yet it is doubtful that the exchange rate trends of the last two years will soon be reversed.

In particular, global payments imbalances are so large as to require further dollar depreciation (see Morgan Guaranty Trust, 1987b). This is true even though the G-7 nations appear to have adopted implicit target zones for their currencies, centred on 145 yen or 1.85 marks per dollar. They also are willing, should the need arise, to fight the dollar's appreciation. But that willingness has limits, for both Japan and West Germany are reluctant to pile up more dollars in their foreign exchange reserves. If tested, they will eventually have to let the dollar fall, though they can smoothen the decline. Exchange rates closer to 125 yen or 1.70 marks per dollar are likely to predominate by the end of 1988. In the

interim, the attempt to fix exchange rates will increase the volatility of interest rates, and may also introduce an upward bias in interest rates to compensate for the risks once the targets are changed. It may also lead to a modest increase in global inflation, as pressures that would normally be resolved by an appreciation of the yen and mark spill into other channels. As long as high interest rates coincide with moderate growth in the industrial world, however, Asian LDCs should find the situation tolerable – from the perspectives of both trade and finance.

Industrial countries have responded in different ways to the problem of payments imbalances. Tax reform allowed the United States to trim some \$65 billion from its budget deficit in fiscal year 1987, but the trade deficit rose even higher. Yet net exports have started to make a positive contribution to U.S. growth, contributing 1.2 percentage points of the 3.2 per cent growth in GNP from the second half of 1986 to the first half of 1987. Moreover, domestic demand in the United States is at its weakest since the 1982 recession, and many are arguing whether recession in the United States is an unavoidable part of the medicine for correcting the U.S. trade deficit. Caution suggests that it is unwise, both economically and politically, to rely exclusively on the U. S. market while such large deficits exist.

Japan's domestic demand is finally expanding, on the other hand. Growth in real GNP should hit 3.2 per cent in 1987 and in 1988, with domestic demand contributing about 4 percentage points to growth each year and falling net exports subtracting about 0.8 percentage point. Yet Japan's trade surplus (on a customs clearance basis) should fall only to \$65 billion in 1988, from \$83 billion in 1986, which augurs further yen appreciation. Thus, countries should find underlying macroeconomic conditions in the Japanese market attractive – strong growth, an expensive yen, and the political imperative to import. The market is not easy to break into – whether for commodities or manufactures – but should be profitable. And, in dollar terms, it now is equivalent to about 60 per cent of the U. S. market.

Europe, in some ways, appears less attractive. Cautious fiscal and monetary policy in West Germany has held down its growth directly, while working indirectly through the balance of payments to cap growth in other European countries. The individual country markets are also fragmented, with no single market more than one-third the size of the U.S. market. Trade barriers are not negligible, since the European Community protects its poorer members and some of its traditional suppliers (in North Africa, for example). Yet Europe represents almost untapped territory, unlike the American market.

As of 1985, all the Asian nations relied principally on the U.S. market for exports of manufactures (see Table 5; more recent data are not available on a comparable basis). Asian exporters should work to change that orientation because of the attractive opportunities available in Europe and Japan. In addition, many South-east Asian nations will find

their currencies appreciating against the dollar because of their own bilateral surpluses with the United States, although those currencies should not appreciate against the yen and the mark. Thus, cost factors are likely to force increasing efforts at penetrating markets outside of North America. Appreciation against the dollar has already occurred for some currencies, although several currencies in the region remain cheap (see Table 6). Protectionism in general may pose constraints, especially for those countries emphasizing exports of sensitive items such as textiles, clothing, and shoes. Protectionism is not the main reason for de-emphasizing the U.S. market, however; rather, it is the prospect of dollar depreciation and slow growth during the process of correcting the U. S. trade deficit.

Table 5
OECD IMPORTS OF MANUFACTURED GOODS IN 1985

	Total (billions of dollars)	Share of Total (Per Cent)		
		U. S.	Japan	Europe
Far East*	85.51	59	10	24
Burma	0.02	17	29	52
Indonesia	1.49	42	28	26
Malaysia	3.45	54	10	32
Nepal	0.09	56	1	42
Philippines	2.51	63	11	22
Singapore	5.93	62	6	26
Sri Lanka	0.43	59	4	34
Thailand	2.08	46	13	35
South Korea	17.59	59	14	18
Taiwan	23.98	71	7	14
Hong Kong	15.04	58	4	31

* Excluding OECD members.

Table 6
REAL EFFECTIVE EXCHANGE RATES
(Index Numbers, 1980-82 Average = 100)

	1984	1985	1986	1987*
Hong Kong	100	104	95	92
Indonesia	96	95	72	55
Korea	97	89	76	75
Malaysia	120	116	95	91
Philippines	108	115	90	84
Singapore	102	96	80	75
Taiwan	97	95	89	93
Thailand	94	92	78	71

* Average for January through September.

In summary, South-east Asian nations must prepare themselves for further swings in the exchange rates in key currencies, and for the consequent changes in global trading patterns. □

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**Occasional
Papers**

No.	Title	Author
1	The Dynamics of Money and Prices and the Role of Monetary Policy in SEACEN Countries	<i>Mohsin S. Khan</i>
2	The Informal Financial Sector in Developing Countries: Analysis, Evidence, and Policy Implications	<i>Anand D. Chandavarkar</i>
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