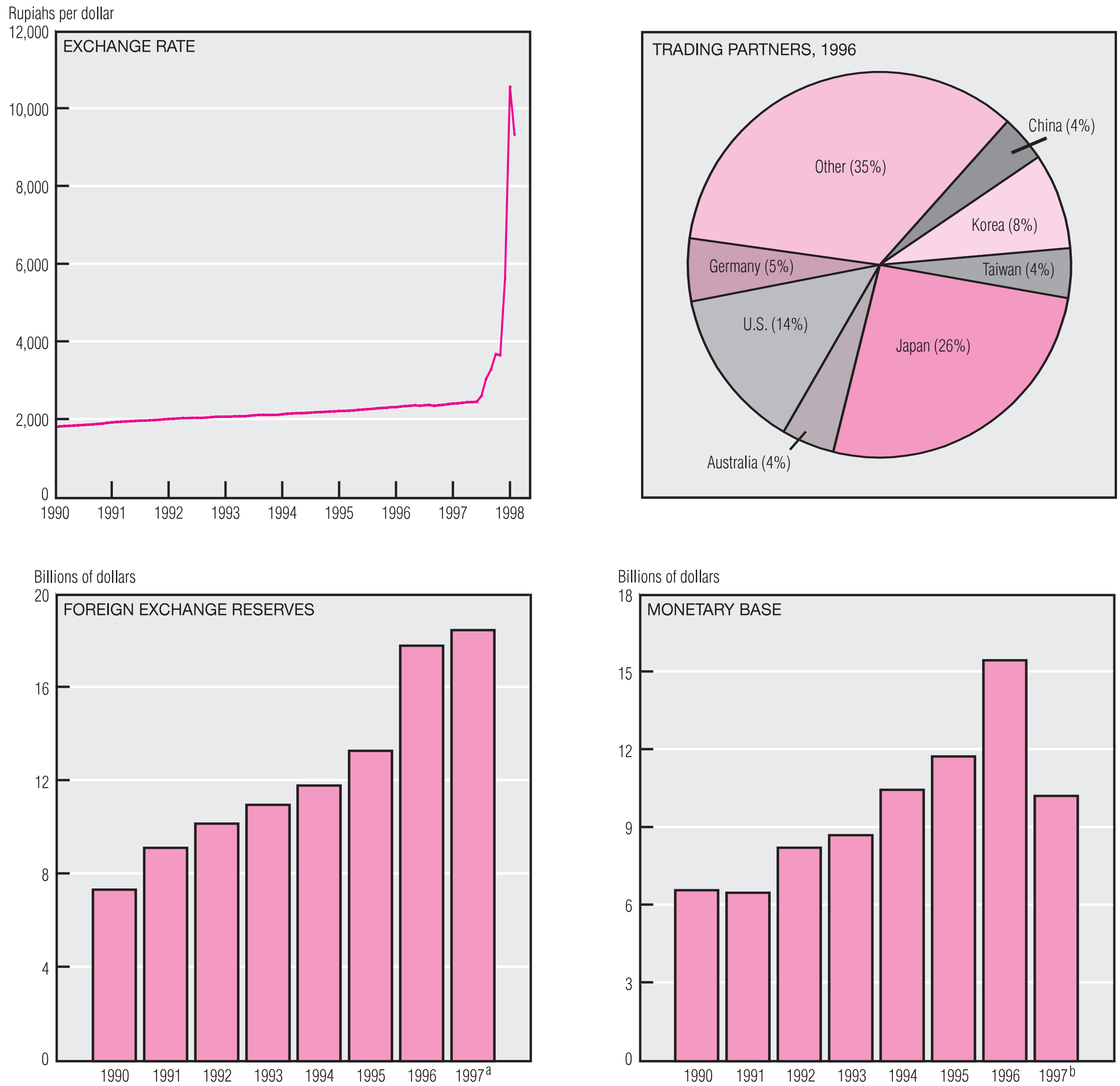
An Indonesian Currency Board?



a. Through October 1997.
b. Through November 1997.
SOURCES: International Monetary Fund, *International Financial Statistics* and *Direction of Trade Statistics*; and *The Wall Street Journal*, various issues.

Indonesia recently considered establishing a currency board, which would exchange rupiah notes for U.S. dollars on demand, with no restrictions. The country would insure this offer by fully backing the rupiah monetary base with dollars and by fixing the exchange rate as a matter of public law. An irrevocable dollar peg with full rupiah convertibility would automatically link Indonesia's money stock to that of the U.S. By precluding Indonesia from engaging in discretionary monetary policy, this arrangement would enhance the credibility of the rupiah's purchasing power.

Doubts about the safety and soundness of the banking industry —not uncertainty about monetary policy—seem to be the key factor driving Indonesia's capital flight. But a currency board cannot remedy a banking crisis quickly. Because it never holds domestic assets of any kind, a currency board cannot act as a lender of last resort (LLR) or otherwise inject funds into the banking system. While an independent LLR is conceivable, its inability to create reserves limits its scope.

Under a fixed peg, any dollar appreciation could reduce Indonesia's trade balance. As this happened, the nation's money stock would contract, prices and wages would fall, and interest rates might rise. When the exchange rate is set, prices and wages must bear the full burden of reestablishing a nation's competitiveness.