

Theory of Currency Basket: Incomplete Exchange Rate Pass-through and Its Weight

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〈SUMMARY〉

This paper shows a relationship between incomplete exchange rate pass-through and currency basket weights under a currency basket policy. It is concluded that trade share weights adopted in many previous studies are the optimal currency basket weights to stabilize terms of trade, under the law of one price. However, in the case of incomplete exchange rate pass-through, adopting a trade-weighted currency basket is not sufficient to stabilize terms of trade because gaps in the exchange rate pass-through cause mismatches between real exchange rates and terms of trade. In this case, we indicate that authorities can stabilize terms of trade by attaching greater weight to the currency exhibiting relatively high exchange rate pass-through.

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