

# Exchange Rate Regimes

Lecture 2  
IME LIUC 2013

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## How many exchange rate regimes do we have?

- **Hard pegs or no legal tender**  
**No separate legal tender**  
The country adopts a foreign currency as legal tender.  
**Currency boards**
- **Intermediate regimes**  
**Other conventional fixed peg arrangements**  
The central bank maintains a fixed exchange rate by intervening in the foreign exchange market and setting interest rates on its facilities. The degree of official commitment to fixed pegs varies across countries. These arrangements are often called soft pegs.

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- **Pegged exchange rates with horizontal bands**  
The central bank keeps the exchange rate inside a preannounced band by intervening in the foreign exchange market
- **Crawling pegs**  
The central bank preannounces a periodic rate of depreciation and supports the preannounced path for the exchange rate by intervening in the foreign exchange
- **Crawling band**  
The central bank keeps the exchange rate inside a band that changes periodically by intervening in the foreign exchange market

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- **Managed floating with no preannounced path for exchange rate**  
The central bank does not commit to any exchange rate target, but smooths out exchange rate fluctuations through intervention in the foreign exchange market.
- **Independent floating**  
The central bank refrains from intervening in the foreign exchange market and sets its monetary policy objectives primarily based on domestic considerations.

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### What is a currency board (CBA)?

A fixed exchange rate is adopted in a law and central bank money (high-powered money) is fully backed by foreign assets.

The central bank will only issue local currency against purchases of foreign exchange.

Lending to the government by the central bank is prohibited and the amount of support to commercial banks in case of a crisis is usually limited to the excess coverage of high-powered money by foreign assets.

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### Advantages and Disadvantages of Fixed and Flexible ER

■ <b>Advantages of fixed exchange rates</b>	■ <b>Advantages of floating exchange rates</b>
- 1) providing a nominal anchor to monetary policy	- 1) giving independence to monetary policy
- 2) encouraging trade and investment	- 2) allowing automatic adjustment to trade shocks
- 3) precluding competitive depreciation	- 3) allowing seignorage
- 4) avoiding speculative bubbles	- 4) avoiding speculative attacks

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**Fixed ER:1) nominal anchor to monetary policy**

- A central bank that wants to fight inflation can commit more credibly by fixing the exchange rate
- Workers, firm managers, and others who set wages and prices then perceive that inflation will be low in the future because the currency peg will prevent the central bank from expanding even if it wanted to.
- When workers and firm managers have low expectations of inflation, they set their wages and prices accordingly.
- The result is that the country is able to attain a lower level of inflation for any given level of output.

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**Fixed ER:2) encouraging trade and investment**

- ER variability would create uncertainty and would discourage international trade and investment.
- In the past, skepticism for three reasons
  - Exchange rate variability reflects variability in economic fundamentals.
  - Anyone adversely affected by exchange rate variability can hedge away the risk
  - empirically, it was hard to discern an adverse statistical effect from increased exchange rate volatility on trade.
- Counterarguments
  - most exchange rate volatility appears to be unrelated to macroeconomic fundamentals.
  - many developing country currencies have no forward markets;
  - Third, more recent econometric studies have found stronger evidence of an effect of exchange rate variability on trade

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**Fixed ER:3) precluding competitive depreciation**

- Argument that goes back to the 30' (1929 crisis)
- In countries that are interdependent, the depreciation by one country put pressure on the others. E.g. each time one country in East Asia or Latin America devalued, its neighbors were instantly put at a competitive disadvantage, (e.g., from Thailand to the rest of East Asia in 1997, and from Brazil to the rest of South America in 1999).

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**Fixed ER:4) avoiding speculative bubbles**

- The final argument for fixed exchange rates is to preclude speculative bubbles of the sort that pushed up the dollar in 1985 or the yen in 1995.
- According to some economists, the strong appreciation of US\$ in 1985 was not determined by fundamentals, but rather was the outcome of self-confirming market expectations (speculative bubble) .
- Some exchange rate fluctuations appear utterly unrelated to economic fundamentals. Therefore, fixing the exchange rate is a way to avoiding the bubbles

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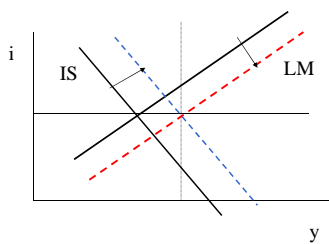
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**Flexible ER:1) giving independence to monetary policy**



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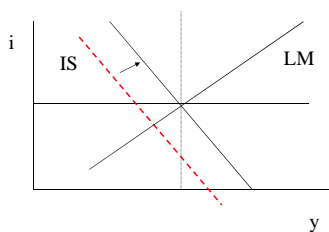
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**Flexible ER:2) allowing automatic adjustment to trade shocks**



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**Flexible ER:3) allowing seignorage**

- **Seignorage** Profit made from printing money
- **Seignorage** equals the amount of new currency that the monetary authority issues.
- With a flexible exchange rate, the stock of money in the economy is decided by the authorities; money creation leads to seignorage:  $\Delta M/P$

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**How to choose?**

- The impossible trinity—of a fixed exchange rate, capital mobility, and a monetary policy dedicated to domestic goals—is surely the major part of the explanation for the non-viability of **soft** pegs.

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**Institutions and ex rate flex.**

- **The value of exchange rate flexibility increases, as economies and their institutions mature.**
- Em. markets have stronger links to int. cap. mark. than do other dev. economies; but unlike ad. economies, em. markets face a variety of institutional weaknesses and macroeconomic volatility (higher inflation, problems of debt sustainability, fragile banking systems) which potentially undermine the credibility of policymakers.
- While the non-emerging-market developing economies may gain credibility through pegging their exchange rates, emerging markets find it harder to do so and could benefit from investing in **"learning to float."**
- More advanced economies, with their stronger institutions, are best positioned to enjoy the benefits of flexibility without the risk of losing policy credibility.

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Rogoff et al. "Evolution and Performance of Exchange Rate Regimes" IMF WP/03/243, Dec 2003.

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