Exchange Rate Regimes

Lecture 2
IME LIUC 2014

1

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.

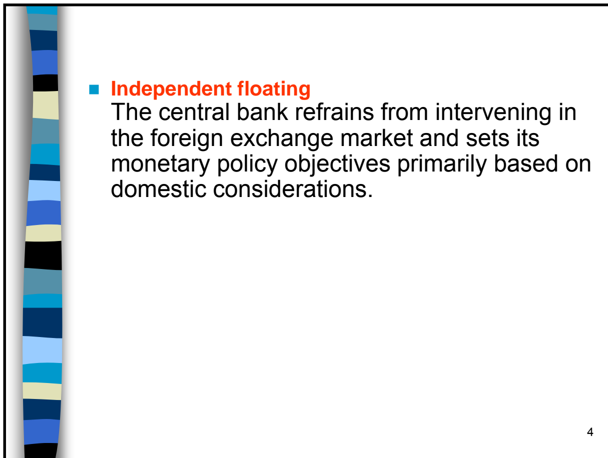
2

Pegged exchange rates with horizontal bands
The central bank keeps the exchange rate inside a preannounced band by intervening in the foreign exchange market

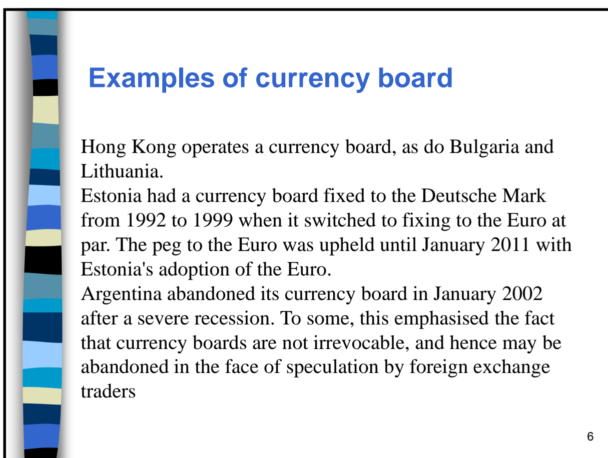
Crawling pegs
The central bank preannounces a periodic rate of depreciation and supports the preannounced path for the exchange rate by intervening in the foreign exchange

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

3


Independent floating
The central bank refrains from intervening in the foreign exchange market and sets its monetary policy objectives primarily based on domestic considerations.
4

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.
5


Examples of currency board
Hong Kong operates a currency board, as do Bulgaria and Lithuania.
Estonia had a currency board fixed to the Deutsche Mark from 1992 to 1999 when it switched to fixing to the Euro at par. The peg to the Euro was upheld until January 2011 with Estonia's adoption of the Euro.
Argentina abandoned its currency board in January 2002 after a severe recession. To some, this emphasised the fact that currency boards are not irrevocable, and hence may be abandoned in the face of speculation by foreign exchange traders
6

Advantages and Disadvantages of Fixed and Flexible ER

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

7

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.

8

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
  - 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
  - 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

9

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).

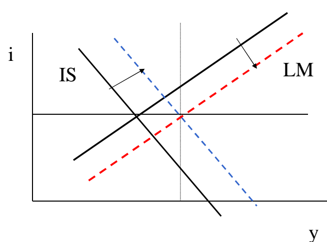
10

Fixed ER:4) avoiding speculative bubbles

- Ex. the dollar in 1985 or the yen in 1995.
- According to some economists, the strong appreciation of US$ in 1985 the 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

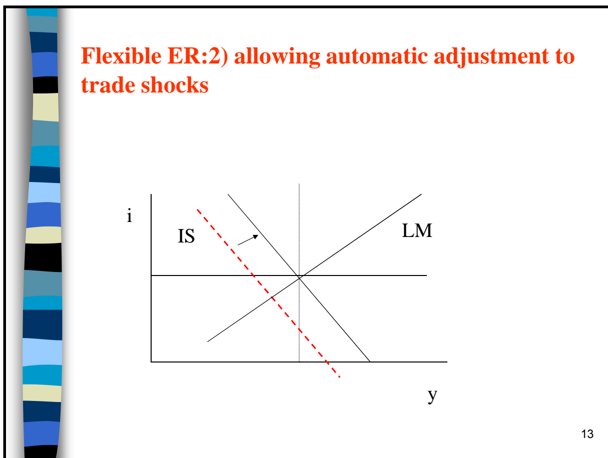
11

Flexible ER:1) giving independence to monetary policy



12

Flexible ER:2) allowing automatic adjustment to trade shocks



13

Flexible ER:3) allowing seignorage

- *Seignorage* difference between the value of currency and the cost of producing it. It is the profit earned by the government by printing currency.
- With a flexible exchange rate, the stock of money in the economy is decided by the authorities; money creation leads to seignorage: ΔM/P

14

How to choose?

•Corner solutions: countries should move away from the intermediate regimes, in favor of either the hard peg corner or the floating corner became the new conventional wisdom with the emerging market crises of the late 1990s. (idea behind: intermediate degree of exchange rate flexibility is inconsistent with perfect capital mobility - principle of the Impossible Trinity).

country characteristics: approach
- J Frenkel (2011)
- K Rogoff (2003)

15

J Frankel – Country characteristics

- 1. Small size and openness (ratio of tradable goods to GDP).
- 2. The existence of a major-currency partner with whom bilateral trade, investment and other activities are already high, or are hoped to be high in the future.
- 3. Symmetry of shocks. (high correlation of cyclical fluctuations between the home country and the country that determines policy regarding the money to which pegging is contemplated).
- 4. Labor mobility. When monetary response to an asymmetric shock has been precluded, it is useful if workers can move from the high-unemployment region to the low-unemployment region.
- 5. Countercyclical fiscal transfers. (US federal fiscal system)
- 6. Countercyclical remittances.
- 7. Political willingness to give up some monetary sovereignty.
- 8. Level of financial development. Countries seldom float without first having developed financial markets.
- 9. Origin of shocks.

J. Frankel: Choosing an Exchange Rate Regime, Harvard Kennedy School 2011

16

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 heir 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.

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

17