



Exchange Rate Arrangements: Fixed, Pegged or Floating? Which is Best When and Where?

Introduction: Economic growth experts need to be familiar with this subject and with the pros and cons of the various kinds of exchange rate arrangements, or, as they are sometimes called, exchange rate regimes. Reasons for the necessity include the importance of the exchange rate and exchange rate policy for a country's macroeconomic situation and economic growth prospects. Sometimes highly technical issues arise. These are often not easy matters to understand and manage.

Often in developing countries important issues are involved, issues that matter to USAID programs in private sector development, agriculture, and other sectors, and as well as the overall management of the macro-economy. Other actors including the International Monetary Fund (IMF) and the World Bank often take the lead on these matters within the donor community. USAID in many instances has technical assistance advising the government on how to deal with these issues. This helps to assure that activities consistent with good macroeconomic policy and practice supported by USAID in the country are dealt with reasonably by the assisted government.

Exchange-rate stability and balance-of-payment equilibrium have been hard to achieve for many countries. Significant and highly controversial technical issues are actively under discussion in the advanced economics literature regarding how these matters have been managed in the recent past, including the experiences with Mexico in the 1980s and the early 1990s, the Asian Financial Crisis, the Russian Crisis of 1998, and the fall of the Argentine peso in early 2002. The IMF has continued to defend often controversial judgments. This technical brief lays out the issues and reports on some recent empirical evidence on the effects of different exchange rate arrangements on inflation and real economic growth.

A country's choice of exchange rate regime may have substantial implications for its price level stability, its general macroeconomic stability, choice between the exchange rate and the monetary policy instrument as the principal tool for monetary/exchange rate policy, and the relative roles of monetary and fiscal policy play in managing the macro economy. The main exchange rate concerns are: achievement and maintenance of currency convertibility, avoidance of multiple rates of exchange for a currency, and how the choice between fixed and flexible exchange rates is played out. Key exchange rate regime approaches are pegged and floating exchange rates. There is a very substantial economics literature addressing these various choices. One example of the kinds of complexity that may arise is that, when the choice is a fixed or pegged rate, policy-makers need to choose whether the peg should be adjusted only in large increments at very infrequent intervals, or whether (the more flexible option with this category) the peg should be adjusted fairly often, in small increments. The latter approach helps to avoid unsustainably large balance of payments deficits or surpluses. And the size of the allowable trade deficit for these purposes may depend on such factors as the amount of grant assistance or new external loans its government is receiving and the adequacy of its macroeconomic policies.

The standard balance of payments account addresses both "above the line" (what is to be financed) and "below the line" questions (what does the financing).. Conventions explain which items are counted where. This is relevant as "below the line" items are legitimately considered means of financing rather

Technical Briefings is published by USAID/EGAT Office of Economic Growth in Washington, DC. It aims to share technical and analytical information with USAID field missions, especially with economic, private sector, and agricultural development officers. Any views, interpretations, and conclusions expressed in *Technical Briefings* are those of the author (s) alone and do not represent any official views of USAID or the U.S. Government. If you have feedback, ideas or comments about Technical Briefings, please contact Jim Elliott (jelliott@usaid.gov). Suggestions for subjects are always welcome. This Technical Briefing was authored by Bob Aten and Jim Elliott with substantial input from Shewitt Habtemichael.

than balance of payments items directly. Both grants and most loans as identified above are counted as receipts above the line in the balance of payments. Thus, as positive items recorded above the line, they make a balance of payments deficit to be financed smaller than it would otherwise be. There are negative factors that are counted above the line, such as imports of goods and services. So, grants and receipts help to finance imports. When there are deficits above the line, they must be financed. When there are problems, such factors as special balance of payments assistance and debt rescheduling, based on an IMF program agreed between the government and the IMF, go “below the line.”

Current values of exchange rates for major currencies are available on a daily basis in newspapers such as the Washington Post, in the form of a table like the following excerpted from a larger table published on Thursday, June 1, 2006 in the *Washington Post* (Section D, page 11)

FOREIGN EXCHANGE									
Currency	Foreign currency in dollars		Dollar in Foreign currency			Foreign currency in dollars		Dollar in Foreign currency	
	Current	Previous	Current	Previous		Current	Previous	Current	Previous
Argentine peso	0.3240	0.3238	3.0862	3.0887	India rupee	0.0216	0.0217	46.220	46.130
China -yuan	0.1247	0.1245	8.215	8.0300	Malaysia	0.2756	0.2765	3.6290	3.617
Euro	1.2814	1.2865	0.7804	0.7773	Philippines	0.0189	0.0191	52.89	52.35
Hungary	0.0049	0.0049	204.41	202.70	Russia ruble	0.0371	0.0371	26.9437	26.9312

Factors to be noted about the table include that most often such tables are expressed in U.S. dollars (i.e. in dollars U.S. per foreign currency unit or numbers of the foreign currency units per U.S. dollar). This is partially for convenience, but it is also because the dollar is the world’s main reserve currency, in which payments and settlements are made and central banks hold their reserves. There are ongoing discussions about whether the dollar will continue to be the world’s main reserve currency.

In a multi-currency world, exchange rate arrangements¹ for converting countries’ currencies into currencies of other countries are essential in order to support a process in which international transactions in goods and services and investment take place efficiently. Moreover, as trade in goods and services increases, such arrangements must work on a growing scale.² Since international trade and investment are key factors supporting international economic growth, exchange rate arrangements are important to USAID’s economic growth work.

In this note, only a limited number of the wide variety of exchange rate regimes that exist have been discussed. Beyond what has already been discussed, there is a rich and highly controversial literature on which exchange rate arrangements work better than others in maintaining macroeconomic stability and promoting prompt adjustment to external and internal shocks to a country’s economy, at least for certain countries, and under certain circumstances. All of these factors depend to some extent on judgments made in financial markets about the strength and weakness of currencies and their likely evolution. We next discuss a couple of key factors, fixed and flexible exchange rates.

Fixed and flexible exchange rates: For more than 30 years, there has been no agreed international system of fixed exchange rates. Under such a system, in the different international economic world of 1945 - 1973, occasional devaluations and upward revaluations of some currencies were often sufficient to keep an appropriate international balance. Over recent decades, countries have experimented with a variety of strategies for setting, and adjusting as necessary, the foreign exchange (foreign currency) value of their national currencies. These strategies range from letting the currency “float” freely so that market forces

determine the exchange rate without interference from the monetary authorities as it “sinks” or “rises” to its “natural level” - to adopting various pegging and fixed exchange rate arrangements/measures under which a country’s monetary authorities undertake market transactions to keep the national currency’s value fixed in terms of some other national currency or even a supra-national currency, adjusting a pegged rate frequently, and so on.³ The US allows the dollar to float freely, subject to occasional efforts by Federal Reserve Bank Chairmen and Secretaries of the Treasury to talk it up or down. This is possible because the US dollar is the main international reserve currency. Moreover, many, indeed most, countries persist to this day in fixing their exchange rates in terms of that of another country (“single country peg”) or pegging their currencies to some other currency or “basket” of currencies. Other countries may pretend that they float but may also secretly intervene – described often as allowing their currencies to float either “independently” or in some kind of a managed or “dirty” float.⁴

Which exchange rate regime works best? The current debate which has been ongoing for some time is largely about whether a country should fix its currency’s exchange rate in nominal terms with the dollar or some other currency such as the Euro, or let the rate float to be determined by the forces of supply and demand in foreign exchange market, or peg adjustably to another currency or basket of currency. Often international organizations such as the IMF will have views about how this process should proceed. It is claimed that different exchange rate regimes have different implications for how fast and how well the country’s economy adjusts to changes in fundamental factors affecting its balance of international payments between residents and nonresidents, as well as for control of inflation, and encouragement of foreign trade growth. We illustrate these matters with a discussion of how a fixed exchange rate and a flexible exchange rate normally work.

How a fixed exchange rate policy works: A fixed exchange rate regime might better be called “the fix the exchange rate (foreign currency price of the national currency) and, if necessary, devalue (lower the foreign currency price of the national currency) when it becomes too difficult to maintain the rate” regime. It works well as long as the balance of international payments between residents and non-residents does not shift out of equilibrium for an extended period. But such shifts happen frequently. When the deficit is temporary, say due to a quickly reversible deterioration of the terms of trade (a major agriculture crop fails that is terribly important to a country’s exports), such a deficit can be financed. However if such a deficit persists (a country’s exports of automobiles are persistently undercut by a competitor country), a change in the exchange rate of the deficit country’s currency will be required relative to the country’s general price level, to restore balance between the country’s international payments and receipts above the line. This factor will of necessity lead to a reduction of domestic expenditure on both imports and in total. The idea is through the price change brought about by the exchange rate change to free up more resources for exports and bring its balance of payments back into equilibrium. In order to accomplish this if its currency is pegged to the U.S. dollar or a principal trading partner’s currency the country ensure that its price level rises more slowly than other countries’ are doing on average. To do this it must tighten the discipline of its monetary and fiscal policy and maintain this tighter discipline over a considerable period of time. This is commonly referred to as adjustment by deflation or disinflation.

A return to balance of payments equilibrium may be achieved as described above, but, the same result can be achieved much more quickly by a devaluation of the currency. Of course, because exports and imports already under contract will take time to deliver, for a period, despite eventual improvement, the balance of payments deficit will worsen. Moreover, the increases in a country’s exports and its increased production of import-substitutes for the home market are therefore likely to take place, but not at a rapid pace. During

the interim period when the balance of payments deficit worsens, reserves must be run down or more external financing be obtained. Because of this adverse impact, waiting too long to devalue can be very costly in terms of foreign currency reserves spent by the central bank and interest on external debt incurred to finance the deficit and rebuild reserves.

Devaluation of the currency, or deflation of the domestic price level due to the balance of payments deficit's tendency to reduce the supply of money will almost always lead to an eventual improvement in the balance of payments. There is an unlikely exception. If a country's exports are so large relative to total world demand and supply so that their expansion causes a significant fall in the world prices of the exports, then the increase in exports may not help improve its balance of payments. This exception is almost entirely theoretical.

Flexible exchange rate arrangements: Proponents of a flexible or floating exchange rate arrangement argue that adjustments do not take place sufficiently quickly. Economics Nobel prize winner Milton Friedman (Friedman 1953) made these arguments very early (Friedman 1953). Such proponents continue to argue that the exchange rate adjustment process involved in deflation or disinflation is unsatisfactorily slow and painful. Thus, the process already described involves high costs of unemployment and losses of potential output while the prices are "being got right". Basically, the prices of the country's domestically produced and consumed but internationally non-tradable goods are expected to be typically rigid downward, falling only after considerable inventories of unsold goods have accumulated and unemployment and distress have developed. For a very considerable period of time the currency remains "overvalued" – priced too high in terms of dollars and other currencies for there to be any significant or desirable reduction of the balance of payments deficit to levels that can be sustainably financed.

Such proponents believe that, instead of just devaluing the currency by large amounts to from time to time to deal with emerging balance of payments imbalances, the authorities should let the currency's exchange rate "float" – allow the exchange rate to be determined from day to day by the market – without the authorities' trying to peg it at any particular level. The expectation is that future payments imbalances would be avoided. Under this kind of arrangement – a flexible or floating exchange rate arrangement - the monetary authorities would not have to risk running down their holdings of international reserves defending a particular pegged rate of the currency. Instead they could concentrate on building up and holding a high enough level of interest-bearing international reserves for emergency purposes – i.e., to be able to finance imports for a reasonable period of time in case of some future external shock such as a sharp fall in the international market prices of the country's main exports. This approach sounds convincing, and the US with its reserve currency role is the most successful example of a country following such an approach. Problems may arise: the example of Nigeria, an oil rich country, seems to show that the exchange rate can be flexible for a long time without depreciating enough to bring about a sustainable balance of payments outcome.

Advocates of a fixed or pegged arrangement object to the floating exchange rate solution because of what they consider to be its inflationary bias. If the exchange rate is floating, the monetary authorities can adopt an expansionary monetary policy without fear of balance of payments consequences. The country's price level may rise faster than that of the average country but its currency's exchange rate depreciates in step with this. This policy option is likely to be convenient in the short run. It may be too convenient. One concern is that that ultimate result may be an inflationary spiral due to ever worsening expectations and bad macroeconomic policies induced by the convenience of the arrangement. That is, as the monetary

authorities expand domestic credit and the money supply, the result will be an increased demand for imports. That demand will upset the balance between exports and imports. Without other adjustments, the next step could be a depreciation of the currency. Such a depreciation will lead to an increase in the domestic currency prices of traded goods. The spiral may continue in the absence of a firm policy hand on the macroeconomic environment. Result: another round of expansion of domestic credit and the money supply and to a further depreciation of the currency. As this process goes on, there are likely to be speculative capital outflows as speculators anticipate ever further depreciation of the currency.

There is a problem with this horror story. The same policy mistakes can occur in a country on a fixed exchange rate. (We will refrain from giving any specific examples but readers can doubtless think of some on their own). When the balance of payments deficit and external debt get too large, speculators anticipate a major devaluation and are likely to place their bets against the currency. Businesses and individuals try to speed up payments on bills denominated in foreign currency (thereby increasing market demand for foreign currency), and to postpone collection of amounts due in foreign currencies. This approach is especially likely if such businesses and individuals are obliged to surrender all or most of the foreign exchange proceeds to the monetary authorities at the current exchange rate. Such a policy is often induced as a stop-gap measure by monetary authorities in trouble, but tends to make the trouble worse. The effect is to reduce the supply of foreign currency to the economy. Unless the central bank can and wants to draw on further external credit, it will have to devalue the currency. Eventually the external credit comes at prohibitive rates of interest.

Empirical results about fixed exchange rates. Do fixed exchange rate arrangements work to moderate inflation as advocates of fixed exchange rates claim, relative to more flexible exchange rates such as floating or a frequently readjusted crawling peg? If they do, is this at the expense of real economic activity, employment and exports? Various studies have found that there is a strong empirical link between pegged exchange rates arrangements and low inflation. The IMF study by Ghosh *et al.* (1995) evaluated the macroeconomic performance of 123 developing countries in terms of inflation and output growth and found that the median rate of inflation in countries with pegged exchange rates has been consistently lower than in countries with flexible exchange rates. This IMF study found that countries with fixed exchange rate experience lower rates of inflation while in terms of output growth there is no difference. Using a sample of 52 developing countries, Edwards (1993) finds similar results. Anchoring the exchange rate to a foreign currency imposes discipline and sustains the value of the currency through greater confidence in it. A number of developing countries have-at least from time to time successfully used pegging as an anti-inflationary tool. However, it is not fully clear whether a fixed exchange rate causes low inflation or whether countries with low rates of inflation choose this arrangement. For now we can say that fixed exchange rate regimes seem to promote monetary discipline, and through it lower inflation. Moreover, one must keep in mind what has happened in the last ten years, since the studies were published. Most models do not forecast very well “out of sample.”

Empirical results about flexible exchange rates: What about flexible exchange rates? Do they work well or not? Various studies have found a positive correlation between flexible exchange rates and inflation. Leiderman and Bufman (1996), however, find that a number of small open economies have successful experiences with exchange rate flexibility often coupled with inflation targeting. Inflation targeting means to establish a rate of inflation considered tolerable, and use appropriate monetary/exchange rate policies, possibly accompanied by fiscal efforts to assure that inflation stays sufficiently close to the target. (Australia, New Zealand, Sweden, Israel, Colombia, Chile are among the countries that have

successfully adopted such approaches, which are valued in the economics literature at present). Studies do not find an empirically demonstrable link between the introduction of floating exchange rates and any slowing down in the rate of growth of international trade. In fact, by substituting as necessary for the establishment of export and production subsidies and for the erection or raising of tariff and non-tariff barriers, floating exchange rate arrangements may promote as much as they may discourage the expansion of international trade. It should come as no surprise that recently attention has focused on the extent to which a country with balance of payments surpluses are not allowing its currency to adjust as much as it should, rather than on the extent to which it has or has not lowered tariff and non-tariff barriers to imports.

USAID missions have an interest in what happens to the macroeconomic regimes in countries in which they work. Especially if some of the signs of problems with exchange rate management discussed above tend to occur, there are concerns especially where USAID is a big player there could be adverse effects on USAID activities that arise from policy and technical mistakes by developing countries. This technical brief suggests some of the problems that may arise, and suggests efforts on the part of missions to monitor, assess, and evaluate exchange rate policies as appropriate.

Annex I includes definitions of key technical terms from the IMF. Annex II provides a listing of which countries may be classified as having fixed exchange rates and which countries may be classified as having floating exchange rates. But as has been discussed, there are many varieties of approaches by countries to establishing exchange rates, and an examination of the detail of how a country is operating is probably necessary to understand the current status and trend regarding its exchange rate regime. Annex III provides a table of dollar exchange rates of some currencies in early 2005 and a short list of questions to test the reader's understanding of exchange rate changes.

Bibliography

- 1) Collins, Susan M. "Multiple Exchange Rates, Capital Controls, and Commercial Policy." Chapter 7 in Dornbusch and Helmers, eds. *The Open Economy, Tools for Policy Makers in Developing Countries* (1993).
- 2) Dornbusch, Rudiger. and F. Leslie Helmers. *The Open Economy, Tools for Policy Makers in Developing Countries* Washington, D.C.: Oxford University Press, for the World Bank, World Bank EDI Series in Economic Development, first printing 1988. fourth printing,
- 3) De Grauwe, Paul, "*Exchange Rate Variability and the Slowdown in Growth of International Trade*," IMF Staff Papers, *March 1988*.
Edwards, Sebastian., "Exchanges Rates as Nominal Anchors," *Weltwirtschaftliches Archiv*, No.1, pp.1-32, 1993.
- 4) Friedman, Milton, 1953. "The Case for Flexible Exchange Rates" in *Essays in Positive Economics*. University of Chicago Press.
- 5) Ghosh, A., A. Gulde, J. Ostry, and H. Wolf, "Does the Nominal Exchange Rate Regime Matter?," *IMF Working Paper 95/121*, November 1995.
- 6) Leiderman, L. and G. Bufman, "Searching for Nominal Anchors in Shock-Prone Economies in the 1990s: Inflation Targets and Exchange Rate Bands," Working Paper 16-96, Foerder Institute for Economic Research, Tel-Aviv University, June 1996.

ANNEX I: DEFINITIONS FROM THE IMF

The IMF currently distinguishes fixed from pegged exchange rate arrangements. **Fixed exchange rates** can be classified under two categories: "**Exchange Arrangements with No Separate Legal Tender**" - the currency of another country or region circulates as the sole legal tender or the member belongs to a monetary or currency union in which the same legal tender is shared by the members of the union; and "**Currency Board Arrangements**" - A monetary regime based on an explicit legislative commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate, combined with restrictions on the issuing authority to ensure the fulfillment of its legal obligation. Intermediate between fixed and floating exchange rates are pegged exchange rates. **Pegged rate currencies** are a kind of half-way house between fixed rate and floating rate currencies. Pegged rates are allowed to vary up or down considerably (e.g. plus or minus 15% or more) relative to the central pegged value before the monetary authorities have to intervene in the foreign exchange market to sell or buy foreign

exchange to keep the rate from going beyond the maximum limit in either direction. There are three categories of pegged exchange rates: **Conventional Fixed Peg**; **Pegged Exchange Rate within horizontal bands**, allowing some flexibility of the exchange rate; and **Crawling Pegs**.

The **Floating Rates** category also comprises three subcategories: According to the IMF, floating exchange rates can be classified under three categories: **Independently floating**- when the exchange rate is market determined, with any foreign exchange intervention aimed at moderating the rate of change and preventing undue fluctuations in the exchange rate, rather than at establishing a level for it; **Managed floating with no pre-announced path for exchange rate**- when the monetary authority influences the movements of the exchange rate through active intervention in the foreign exchange market without specifying, or pre-committing to, a pre-announced path for the exchange rate; **Exchange rates with crawling bands**-when currency is maintained within certain fluctuation margins around a central rate that is adjusted periodically at a fixed pre-announced rate or in response to changes in selective quantities indicators. Closest to the Crawling Peg subcategory above are **Exchange Rates within Crawling Bands**. Then comes **Managed Floating with No Pre-announced Time Path for Exchange Rate**; and finally **“Independent Floating”** which comes close to the *laissez faire* ideal advocate’s epitome of fully market determined rates.

ANNEX II: Fixed and Flexible Exchange rate arrangements as of end of December 2002:

A. COUNTRIES/POLITIES WITH FIXED OR PEGGED EXCHANGE RATES

Fixed Exchange arrangements with no separate legal tender: (41) Euro Area: **Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain**; Adoption of US dollar or dollar peg: **Ecuador, El Salvador??** Another currency as legal tender: **East Timor, Panama; (US dollar) Kiribati, Marshall Islands, Micronesia, Fed. States of, Palau, San Marino**; Exchange Rate Anchor arrangements: **East Caribbean Dollar of ECCU: Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines**; **CFA franc zone, WAEMU: Benin, Burkina Faso, Cote d’Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo**; **CFA franc zone, CAEMC: Cameroon, Central African Republic, Chad, Congo, Rep. of, Equatorial Guinea, Gabon** Fixed Exchange Rates: Currency board arrangements: (7) **Bosnia and Herzegovina, Brunei Darussalam, Bulgaria, China-Hong Kong SAR, Djibouti, Estonia, Lithuania**. Pegged Exchange Rate Systems (Other Conventional Peg Arrangements: Against a single currency (32): **Aruba, Bahamas, Bahrain - Kingdom of, Bangladesh, Barbados, Belize, Bhutan, Cape Verde, China - P.R., (China is described as having a monetary aggregate target) Comoros, Eritrea, Guinea, Jordan, Lebanon, Lesotho, Macedonia, FYR, Malaysia, Maldives, Namibia, Nepal, Netherland Antilles, Oman, Qatar, Saudi Arabia, Sudan, Suriname, Swaziland, Syrian Arab Republic, Turkmenistan, Ukraine, United Arab Emirates, Zimbabwe**. Against a composite of currencies (10): **Botswana, Fiji, Kuwait, Latvia, Libyan Arab Jamhiriya, Malta, Morocco, Samoa, Seychelles, Vanuatu**.

COUNTRIES/POLITIES WITH FLOATING RATES Exchange Rate with Crawling Bands: (5) **Belarus, Honduras, Israel, Romania, Slovenia**; Flexible exchange rate with “managed floating”: (45) **Gambia, Ghana, Guyana, Indonesia, Iran, I.R of Jamaica, Mauritius, Sao Tome and Principe, Czech Republic, Thailand, Argentina, Azerbaijan, Cambodia, Ethiopia, Kenya, Kyrgyz Rep., Lao PDR, Moldova, Mongolia, Pakistan, Rwanda, Serbia and Montenegro, Tajikistan, Vietnam, Zambia, Afghanistan, Algeria, Angola, Burundi, Croatia, Dominican Republic, Guatemala, Haiti, India, Iraq, Kazakhstan, Mauritania, Myanmar, Nigeria, Paraguay, Russian Federation, Singapore, Slovak Republic, Trinidad and Tobago, Uzbekistan** Independently floating rate: (37) **Malawi, Sierra Leone, Sri Lanka, Uruguay, Venezuela, Yemen, Australia, Brazil, Canada, Chile, Colombia, Iceland, Korea, Mexico, New Zealand, Norway, Peru, Philippines, Poland, South Africa, Sweden, Turkey, United Kingdom, Albania, Armenia, Congo Dem. Rep, Georgia, Madagascar, Mozambique, Tanzania, Uganda, Japan, Liberia, Papua New Guinea, Somalia, Switzerland, United States**.

Source: IMF, *Annual Report*, Annex on Exchange Arrangements

ANNEX III Exchange Rates of Some Selected Currencies in the Recent Past

FOREIGN EXCHANGE									
Currency	Foreign currency in dollars		Dollar in Foreign currency			Foreign currency in dollars		Dollar in Foreign currency	
	Current	Previous	Current	Previous		Current	Previous	Current	Previous
Argentine peso	0.3448	0.3448	2.9000	2.9000	India rupee	0.0229	0.0230	43.620	43.400
China –yuan	0.1208	0.1208	8.271	8.271	Malaysia	0.2632	0.2632	3.7795	3.7795
Euro	1.2775	1.2780	0.7828	0.7825	Philippines	0.0182	0.0183	55.02	54.59
Hungary	0.0052	0.0053	191.39	189.36	Russia ruble	0.355	0.0357	28.1900	28.0130

From *Washington Post*, Thursday, February 10, 2005 Exchange Rates, Selected Currencies

Exercise to test your understanding.

1) Compare the table above from early 2005 with that in the text from June 1 2006. Which currencies seem to have appreciated in terms of the U.S. dollar between the two dates? Which ones seem to have depreciated in terms of the U.S. dollar?

2) Which countries would you expect to have growing balances of payments surpluses or shrinking balance of payments deficits? Which ones would you expect to have growing balance of payments deficits or shrinking surpluses?

3) What factors other than the numbers in the two tables would you need to answer question (2) with greater confidence?

ENDNOTES

¹ These are also often referred to as exchange rate regimes or international monetary arrangements.

² For example, U.S. exporters want to receive payments in U.S. dollars so importers of U.S. goods in India have to convert Indian rupees into U.S. dollars to effect payment. The U.S. dollars that the importers of U.S. goods in India buy come ultimately from the dollar proceeds of Indian exports to the U.S. and other countries, and from dollars borrowed by Indian banks from abroad.

³ Sometimes a float is undertaken to let the currency “find its level” in terms of the currency of the country to which it is to be pegged, and then establishing and defending this level as the pegged exchange rate (e.g. Poland in 1990). In 2003, according to the IMF’s listing of exchange rate arrangements of respective countries and regions, the majority of the world’s countries - 100 out of 184 – were pegging their currencies to some major currency or basket of currencies, had established and were maintaining a fixed exchange rate of some kind, or were sharing a common currency. The most recently created of the common currencies is the Euro, which has replaced 12 separate national currencies. The other common currencies, the East Caribbean Dollar (ECD) and the CFA franc, and their respective monetary authorities, have been around for a long time.

⁴ By a fixed rate regime one means one in which the nominal exchange rate of the currency in terms of another country’s currency is fixed within very narrow limits – in the case of the Bretton Woods system the exchange rate of a currency with the US was supposed to be allowed to fluctuate around the central, “parity” only one and a half (1 ½) percentage in either direction, before the monetary authorities of the country were supposed to enter the foreign exchange market, selling or buying dollars as necessary stabilize it closer to the central parity value. Does the IMF’s current classification of “fixed exchange rate arrangements” as comprising only arrangements involving replacement of a national currency by another country’s currency (be it of another country or supra-national) or currency board arrangements seem plausible? The criterion used to be that a fixed rate was one not intended ever to be changed and whose fluctuations around a central par value was limited to no more than 1 ½ percent. At least this is what IMF publications in the early 1990s referred to as a fixed rate. See also textbooks by (1) Kindleberger (1) and (2) Grubler. The rate of fluctuation between units of a shared currency is obviously zero, and a currency board is not supposed to let the nominal value of its currency vary at all in terms of the currency to which it is linked. Note that according to the strictest interpretation of currency boards (Hanke, Jonung and Schuler book on currency boards) some of the currency board countries listed under the currency board category in the IMF’s tables are not truly currency boards).