

Exchange Rate Mechanisms

Fixed and Flexible ER

ER mechanisms

- There are two types of ER mechanisms:
 - Floating ER – no intervention by governments or central banks
 - Fixed ER – officials strive to keep the ER fixed (or pegged) even if the rate that they choose is not the equilibrium rate.
- Managed Exchange Rates fall in-between these two categories

Government Policies toward ER

- “Clean Float” – floating exchange rate with no government participation in the market
- “Managed Float” or “Dirty Float” - floating exchange rate with government influence/participation in the market
- Fixed Exchange Rate – The exchange rate is fixed at some par value, although there is some small degree of flexibility (bands set around par value)

Floating (Flexible) Exchange Rates

- No Government Interference
- Market Forces dictate equilibrium exchange rates
- Value of a nation's currency allowed to "float" down or up
- End of the 1990's – these are the norm

Fixed Exchange Rates

- Predominant exchange rate system in the world for most of 20th century (1900's – 1970s)
- In a fixed exchange rate system, the value of a nation's currency is fixed (pegged) to a fixed amount of a commodity or to another currency
- Commodity – usually Gold (Gold Standard);
Currency – US\$

Commodity Based Fixed Exchange Rates

- 3 rules when fixing exchange rates to a commodity
 - Fix the value of the currency unit in terms of gold (fixed exchange rate)
 - Keep the supply of domestic money fixed in some constant proportion of the gold supply
 - Countries must be willing to exchange gold for their own currency

To What should we fix the ER?

- In addition to gold, ER can be fixed to
 - 1) Another currency (US\$, FF, Euro)
 - 2) “Basket” of other currencies
 - SDR – Special Drawing Rights

Fixed Exchange Rate Mechanisms

- Under a fixed exchange rate, national Supply and Demand for currency may vary, but the nominal exchange rate does not
- Monetary authorities ensure that the rate does not change
- Typically, there are bands set above/below the par value that allow for some small fluctuation in the exchange rate
- Governments must act to counter and appreciation

Fixed ER Maintenance

- Governments must act to counter and appreciation/depreciation of their currency
- Typically this is done by buying/selling foreign currency in the foreign exchange markets
- Ex. If the \$ is appreciating, the US will buy FC (sell \$) – release \$ into the market – increase the US money supply
- If the \$ is depreciating, sell FC (buy \$) – decrease the US money supply

Exchange Rate Maintenance

- In addition to activity in the Foreign exchange markets, a government can defend an exchange rate by:
 - Exchange Controls
 - Tariffs/Quotas
 - Changing Domestic Interest Rates
 - Monetary/Fiscal Policy
 - Switch to a floating ER

Adjustable and Crawling Pegs

- The par value of a fixed exchange rate can be changed- it is nothing permanent
- Adjustable Peg – a fixed exchange rate that can be periodically devalued or revalued if need be
 - Competitive Devaluations
- Crawling Peg – a fixed exchange rate in which regular (frequent?) periodic adjustments

Fixed vs. Flexible ER

- Benefits of a fixed ER
 - Reduce uncertainty associated with ER fluctuations
 - Helps limit inflationary pressures?
- Benefits of a flexible ER
 - Help increase nation’s growth?
 - Liberate macroeconomic policy from maintaining ER- let monetary policy influence domestic economy and not just maintain ER
