

Chapter 19

Fixed Exchange Rates and Currency Unions

Dr. Haight - Sum2010

Housekeeping

- Finish up all reading
- No more quizzes!
- Final exam on Thursday

Introduction

- Why study fixed exchange rates?
 - 1920s: the gold-standard monetary system broke up and was replaced by the Bretton Woods
 - **Bretton Woods:**
 - The international monetary system when the U.S. dollar was tied to gold and all other currencies were tied to the U.S. dollar
 - Most exchange rates were fixed from 1946 to the early 1970s
 - A number of countries worldwide fix (peg) the value of their domestic currency to that of another country

Inconvertible Currencies

- **Inconvertible Currency:**
 - A currency that cannot be freely exchanged for another country's currency.
 - One that cannot be freely traded for another country's currency among domestic consumers and businesses
- **Exchange Controls:**
 - A system where the government is the only legal buyer and seller of foreign exchange
 - Government or central bank becomes a monopolist controlling all sales of foreign currency at a set price.
 - Easy to "fix" the price of foreign exchange

Inconvertible Currencies

- To keep exchange rate fixed, total outflows and inflows must be equal at all times.
- Requires government to control flow of capital into and out of the country
 - Domestic individuals and companies' ability to purchase foreign financial assets is severely limited.

The Difficulties

- Difficulties and Exchange Controls
 - Exchange controls lead to
 - Government initially balancing demand and supply for foreign exchange
 - Eliminated wide swings in exchange rate
 - Difficulties with exchange controls
 - Must deal with government bureaucracy
 - Government sole source of foreign exchange
 - Less quality than free market
 - Efficiency losses with only one provider

More Difficulties

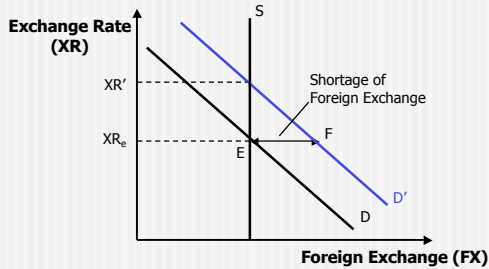
- Difference between nominal and real exchange rates
- If nominal rate close to PPP rate, then relatively sustainable
 - Money supplies in developing countries difficult to control
 - Domestic inflation rate can likely be greater than foreign inflation rate
 - Country's real exchange rate is depreciating and nominal rate is becoming overvalued

Example:

- Assume expansionary monetary policies - price level increases
 - Real exchange rate depreciates and nominal rate is fixed
 - Imports relatively cheaper and domestic demand increasing – rising demand for foreign exchange
 - Excess demand at fixed exchange rate

Example Continued:

Figure 18.2: Demand and Supply of foreign Exchange for Inconvertible Currency Policy Options



What can be done?

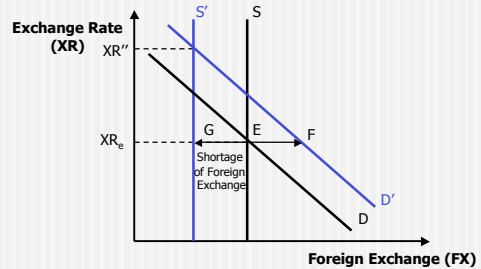
- Balancing demand leaves 3 options:
 - Allow currency to depreciate (AKA Unfix the prices)
 - tends to cause higher inflation and lower GDP
 - Government could implement contractionary policies to reduce demand for foreign exchange (tends to lower GDP)
 - Ration available supply of foreign exchange
 - Government decides who gets the foreign exchange
 - Should provide for necessary imports and deny for unnecessary
 - What is considered necessary?
 - Obviously gives way to large incentives for government corruption

Additional Problems

- Additional problems for economy:
 - Supply of foreign exchange available to country coming from exports decreases
 - Contraction in supply of foreign exchange causes further real exchange rate appreciation
 - Shortage of foreign exchange increases
 - Rationing problem is more severe
 - May cause product and input shortages in domestic markets

Inconvertible Currencies

Figure 18.3: Demand and Supply of Foreign Exchange for Inconvertible Currency Policy Option

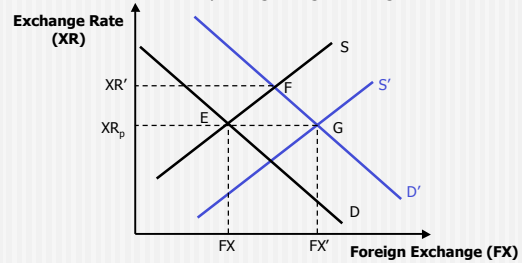


Intervention in the Foreign Exchange Market

- Government may choose to peg their currency to that of another currency
- Example: Mexico
 - **Intervention:**
 - Government buying and selling of foreign exchange
 - Mexico selling foreign exchange increases supply and Mexico buying dollars increases demand.

Intervention in the Foreign Exchange Market

Figure 18.4: Demand and Supply of Foreign Exchange and Government Intervention by Selling Foreign Exchange



Currency Unions

- The situation where two or more countries are all using the same currency
- If really want to keep exchange rate stability between two countries, then more logical to merge two currencies into one
- Obviously benefits and costs associated with this decision

Currency Unions

- Must weigh the size of gains and losses for each country
 - The greater the trade between the countries, the greater the monetary efficiency gains.
- Common currency will ease transaction of capital flows across countries - Increase Efficiency
- Similarly, would be easier to make direct investments (FDI) if did not have to convert currency
- Some uncertainty with investing across borders would be eliminated as well.

Summary

- Most common method of fixing an exchange rate is for a country to have an inconvertible currency.
- A method a country can use to fix an exchange rate is by intervening in the foreign exchange market.
- Government intervention in the foreign exchange market to maintain the exchange rate also affects country's money supply.
- Currency Unions provide an alternative solution