

Exchange Rate Targeting and Currency Boards

FIN 204 Lecture 13.2.

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06 May 2010

- 1 Types of Exchange Rate Regimes
- 2 Main Trends in Exchange Rate Policies Around the World
- 3 Cases of Exchange Rate Regime Choice

Types of Nominal Anchors

To achieve its medium-term goals, the Central Bank sets a nominal anchor:

Nominal Anchor

A behavioral rule for the Central Bank that it should closely pursue a given value for a variable that is: 1) easy to follow by the Central Bank,

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A behavioral rule for the Central Bank that it should closely pursue a given value for a variable that is: 1) easy to follow by the Central Bank, 2) directly influences the medium-term target (inflation); 3) is directly influenced by the Central bank monetary policy actions.

Examples:

- 1 inflation
- 2 monetary aggregates
- 3 exchange rates

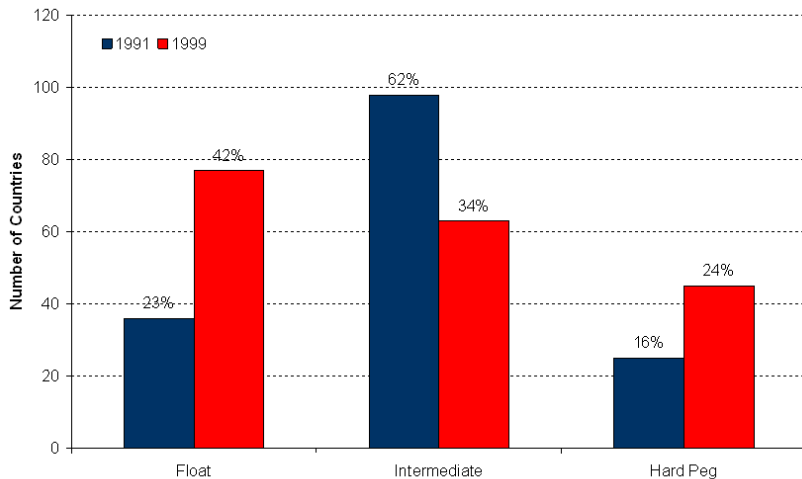
Exchange Rate Regimes

3 main types of exchange rate regimes:

- ① **Floating Exchange Rate:** The exchange rate is market-determined; any CB intervention on the foreign exchange market is aimed at moderating the rate of change and preventing fluctuations in the exchange rate, rather than at establishing a level for it.
 - Examples: USA, Eurozone, Japan.
- ② **Intermediate Exchange Rate Regimes:** the CB tries to achieve some exchange rate stability with the currency of the country's main trading partner; exchange rates may be corrected from time to time to stay within certain bounds
 - Examples: ERM II
- ③ **Fixed Exchange Rate:** The country gives up its exchange rate flexibility
 - Examples: Currency board, Dollarization/Euroization, Currency union

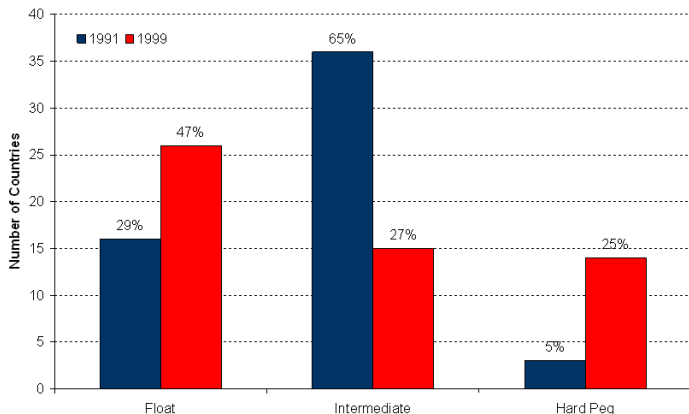
Exchange Rate Regimes

Main Trends: All countries



Exchange Rate Regimes

Main Trends: Developed countries and emerging markets



Source: <http://www.imf.org/external/np/speeches/2001/010601a.htm>

Advantages and Disadvantages of Exchange-Rate Targeting

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- stable prices of traded goods
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- clear rules for monetary policy
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Disadvantages

- shocks are harder to deal with
- speculative attacks are more likely

Determinants of Exchange Rate Regime Choice

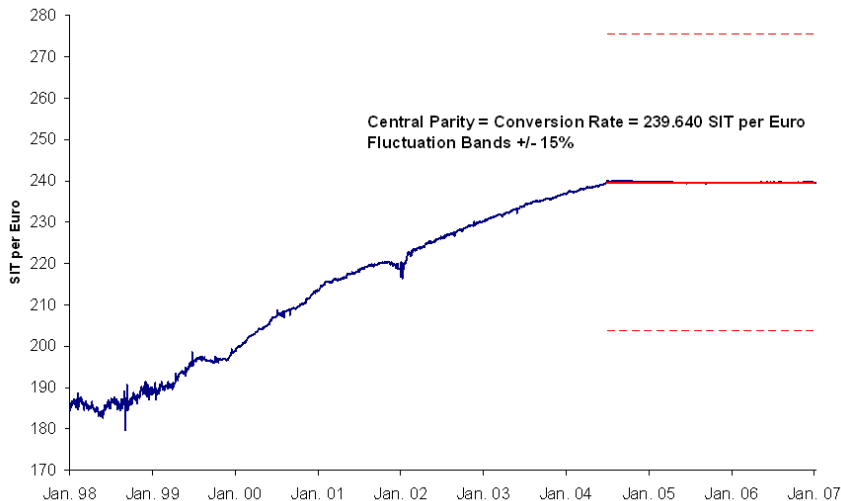
Empirical evidence: Fidrmuc and Senaj (2005)

Applicability of various regimes:

- More open economies are likely to adopt fixed exchange rate
- Countries with a very few major trading partners are also more likely to adopt a fixed exchange rate or an intermediate regime
- Large economies tend to choose flexible regimes

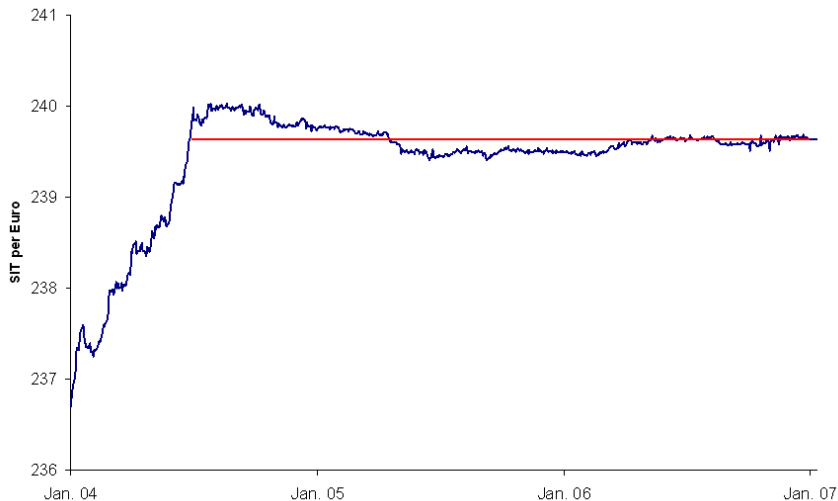
Examples of Intermediate Exchange Rate Regimes

The case of Slovenia



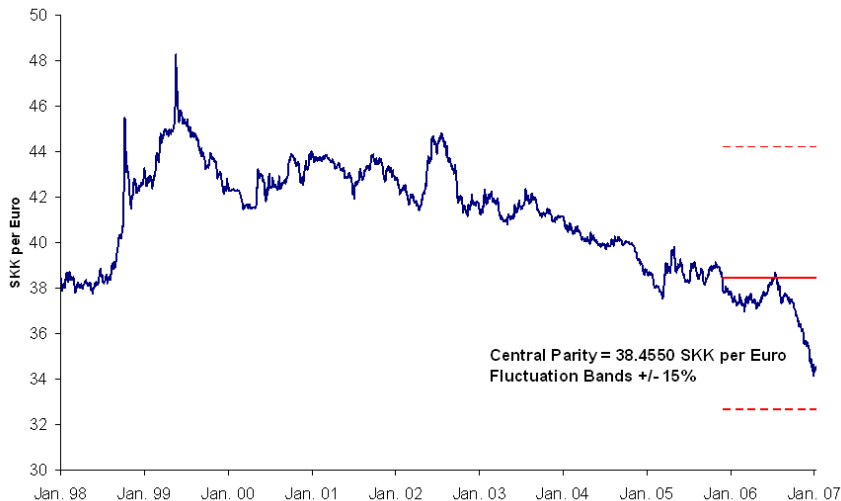
Examples of Intermediate Exchange Rate Regimes

The case of Slovenia (2)



Examples of Intermediate Exchange Rate Regimes

The case of Slovakia



Examples of Fixed Exchange Rate Regimes

The Currency Board Regime

What are currency boards?

Currency Board

Currency Board: A foreign exchange regime in which the domestic currency is backed 100% by a chosen reserve currency, and the exchange rate is *pegged* to the reserve currency at some fixed rate with no option for a freely floating exchange rate or for a managed floating.

Special characteristics of the currency boards are:

- ① legal requirement of the central bank to exchange the local currency for the reserve currency at the chosen exchange rate
- ② discretionary monetary policy is taken (completely) out of the hands of the central bank
- ③ the central bank intervenes only in cases of systemic risk
- ④ the major tool of economic policy is the fiscal policy

A special form of a fixed exchange rate regime is the dollar-/euro-ization.

How Likely is the Euro-Adoption in CEE-4?

Podpiera and Bruha (2007)

The probability of inflation criterion fulfillment

