Fixed Exchange Rates

• East Backwater wants to get the advantage of a stable exchange rate.
• It announces that its central bank will exchange 1 EB = $1.
• It holds reserves of US dollars and, from time to time, buys and sells EB’s on the exchange market to keep the exchange rate in line.

The Basic Concept

• West Backwater wants to maintain an exchange rate of 1WB = 1$

\[ D_{WB} > S_{WB} \]

• WB will be running a positive balance on current account, selling more to the US and other nations than it is buying. The imbalance will reflect itself by dollars flowing into West Backwater.

The Basic Concept

• West Backwater wants to maintain an exchange rate of 1WB = 1$
• It sets up a currency board. The only way you can get more WB is to deposit $.

\[ D_{WB} > S_{WB} \]

• WB will be running a positive balance on current account, selling more to the US and other nations than it is buying. The imbalance will reflect itself by dollars flowing into West Backwater.
• The Money Supply Increases, and inflation brings the trade balance in line!
**Currency Boards**

\[ D_{WB} < S_{WB} \]

- WB will be running a negative balance on current account, selling less to the US and other nations than it is buying. The imbalance will reflect itself by dollars flowing out of West Backwater.

- The Money Supply decreases, and deflation brings the trade balance in line!

**Examples**

- Hong Kong
- Argentina
- Ecuador

**Hong Kong**

- Hong Kong dollar is pegged to the US dollar.
- Banks can issue Hong Kong dollars but only if they deposit US dollars with the currency board.
- You never have to worry about a run, because the bank can get its dollars back when it needs them.
Argentina

• History of high inflation.
• Adopted currency board with Peso = $1.
  – Idea was to make pledge to price stability credible.

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So the government abandoned the currency board.
Ecuador

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- Similar problem, high inflation.
- Adopted currency board to make system credible.
- But, thanks to Argentina, was not believable.
- So...

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Ecuador

- Replaced currency with US dollar.
- It has essentially adopted a monetary union.
- The Federal Reserve System (reasonably credible) sets monetary policy for Ecuador.
- Ecuador gets no say in the price level or the monetary base

Hong Kong

- To be credible, the monetary authority must do nothing but hold reserves at the prescribed exchange rate.
- Hong Kong has not done that.
- Does this cast doubt on the currency board?
End