Currency Boards

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

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- It sets up a currency board. The only way you can get more WB is to deposit $.

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- The Money Supply Increases, and inflation brings the trade balance in line!

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- 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.

$D_{WB} < S_{WB}$

- 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

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- 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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- Ultimately failed, because Argentinean States allowed to issue bonds guaranteed by central government.
- States spend beyond their means, and the government was called on to redeem the bonds.

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Ecuador

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- Adopted currency board to make system credible.
- But, thanks to Argentina, was not believable.
- So…

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- 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