

#### Return to the Gold Standard?

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Fixed Exchange Rates

#### Return to the Gold Standard?

- Some recommend return to Gold Standard, as a means of imposing monetary discipline.
- Most economists, remembering the lessons of the Great Depression, oppose the return.

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Fixed Exchange Rates

# A Virtual Return to the Gold Standard

- Many countries are essentially adopting the gold standard by use of the US dollar as their monetary base.
  - Fixed Exchange Rates
  - Currency Boards

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#### 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.

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#### 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.

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$$D_{FR} = S_{FR}$$

- If the demand and supply of EB's are in line, there is no problem. The central bank of East Backwater can sit back and let traders exchange EB's for dollars.
- Otherwise:



Fixed Exchange Rates

 $D_{EB} \!\!> \!\! S_{EB}$ 

 EB 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 East Backwater.

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Fixed Exchange Rates

## $D_{EB} \!\!>\!\! S_{EB}$

- EB 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 East Backwater.
- The usual solution is to buy the extra dollars, and keep the money in US treasury bills.
  - China
  - Japan
  - Southeast Asia

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Fixed Exchange Rate

 $D_{EB} \!\!>\!\! S_{EB}$ 

- EB 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 dollar. This is called sterilization.
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## This is called sterilization.

- EB 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 dollar: The alternative is do nothing.
- The usua keep the
   The exchange rate will
  - China fluctuate, and the EB will rise
  - Japan relative to the dollar (to say 1
  - Souther EB = \$1.25)

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This is called sterilization.

B will be running a positive balance

- EB will be running a positive balance on current according than by do it would increase the supply
- The total control of EB, allow inflation and hence correct the trade

- <sup>Ch</sup> balance.

- Japan relative to the dollar (to say 1

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## $D_{EB} < S_{EB}$

• If temporary, the central bank can borrow dollars from other nations or the IMF.

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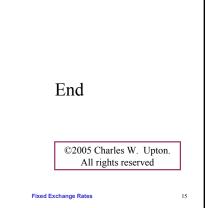
 $D_{EB} < S_{EB}$ 

- If temporary, the central bank can borrow dollars from other nations or the IMF.
- If the imbalance is persistent, the central bank of EB has two choices.
  - Accept devaluation
  - Adopt domestic policies to bring demand and supply in balance.

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