Fixed Exchange Rates

Return to the Gold Standard?

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- Most economists, remembering the lessons of the Great Depression, oppose the return.

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

Fixed Exchange Rates

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- 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.

$D_{EB} = S_{EB}$

- 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:

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The alternative is do nothing. The exchange rate will fluctuate, and the EB will rise relative to the dollar (to say 1 EB = $1.25)

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If EB had a currency board, it would increase the supply of EB, allow inflation and hence correct the trade balance.

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- 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.

End