TYBA
Economics Paper- XIII

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EXCHANGE RATE REGIMES

- Fixed exchange rate regime / Hard Peg System
  i. Gold standard system
  ii. Bretton woods system (IMF) = Dollar exchange rate system
- Flexible Exchange rate regime
  i. Free floating
  ii. Managed exchange rate regime

GOLD STANDARD (1880 -1914)

- From 1871 to 1914, the gold standard was at its pinnacle. During this period, near-ideal political conditions existed in the world. Governments worked very well together to make the system work, but this all changed forever with the outbreak of the Great War in 1914.
- **The Fall of the Gold Standard**
- With World War I, political alliances changed, international indebtedness increased and government finances deteriorated. While the gold standard was not suspended, it was in limbo during the war, demonstrating its inability to hold through both good and bad times. This created a lack of confidence in the gold standard that only exacerbated economic difficulties. It became increasingly apparent that the world needed something more flexible on which to base its global economy.

GOLD STANDARD (1880 -1914)

- The stock market crash of 1929 was only one of the world's post-war difficulties. The pound and the French franc were horribly misaligned with other currencies; war debts and repatriations were still stifling Germany; commodity prices were collapsing; and banks were overextended. Many countries tried to protect their gold stock by raising interest rates to entice investors to keep their deposits intact rather than convert them into gold. These higher interest rates only made things worse for the global economy. In 1931, the gold standard in England was suspended, leaving only the U.S. and France with large gold reserves.

GOLD STANDARD (1880 -1914)

- **The Bottom Line**
- While gold has fascinated humankind for 5,000 years, it hasn't always been the basis of the monetary system. A true international gold standard existed for less than 50 years - from 1871 to 1914 - in a time of world peace and prosperity that coincided with a dramatic increase in the supply of gold. The gold standard was the symptom and not the cause of this peace and prosperity.

- Though a lesser form of the gold standard continued until 1971, its death had started centuries before with the introduction of paper money – a more flexible instrument for our complex financial world. Today, the price of gold is determined by the demand for the metal, and although it is no longer used as a standard, it still serves an important function. Gold is a major financial asset for countries and central banks. It is also used by the banks as a way to hedge against loans made to their government and as an indicator of economic health.

Vehicle Currencies

- **Definition**
- The currency used to invoice an international trade transaction, especially when it is not the national currency of either the importer or the exporter
- The dollar acts as a '**vehicle currency**' in the sense that agents in non-dollar economies will generally engage in **currency** trade indirectly using the US dollar rather than using direct bilateral trade among their own **currencies**. A **vehicle currency** is desirable when there are transactions costs of **exchange**.

Fixed Exchange Rate

- A fixed exchange rate is when a country ties the value of its currency to some other widely-used commodity or currency. The dollar is used for most transactions in international trade. Today, most fixed exchange rates are pegged to the U.S. dollar. Countries also fix their currencies to that of their most frequent trading partners.
- In the past, currencies were fixed to an ounce of gold. In the 1944 Bretton Woods Agreement, countries agreed to peg all currencies to the U.S. dollar.

ADVANTAGES OF FIXED EXCHANGE RATE

- Promotes International Trade and Investments
- Imparts discipline in Macroeconomic policies
- Promotes International Cooperation
- Promotes domestic stability
- No need for frequent changes
- Avoids speculation which has destabilizing effects

Bandagon effect and Rational Bubble

DISADVANTAGES OF FIXED EXCHANGE RATE

- Leads to domestic inflation and deflation
- Does not permit independent internal policies
- Need for large foreign exchange reserves
- Does not react quickly to market forces
- Not necessarily favourable to international investments and lending

Case for Flexible exchange rates

1. Ensure balance of payments equilibrium
2. Monetary autonomy
3. Promotes economic stability
4. Insulates domestic economy
5. Stabilises the private speculation
6. Easy to determine the exchange rate
7. Smooth adjustment in BoP
8. Suitable for full employment
9. Settles at Natural level

Case against Flexible exchange rates

- Creates Uncertainty
- Discourages investment and borrowing
- Lacks stability in Macroeconomic policies
- Irrational speculation
- Poor international co-operation

Managed Float/Managed Flexible Exchange Rate

- Ability to produce a more appropriate rate
- To mitigate costs of overvalued or undervalued exchange rates
- To smoothen the economic adjustment process
- Unsterilized Intervention: maintains Forex reserves to maintain exchange rate
- Sterilized Intervention : uses monetary policy to intervene

Balance Of Payments under Floating Exchange rate

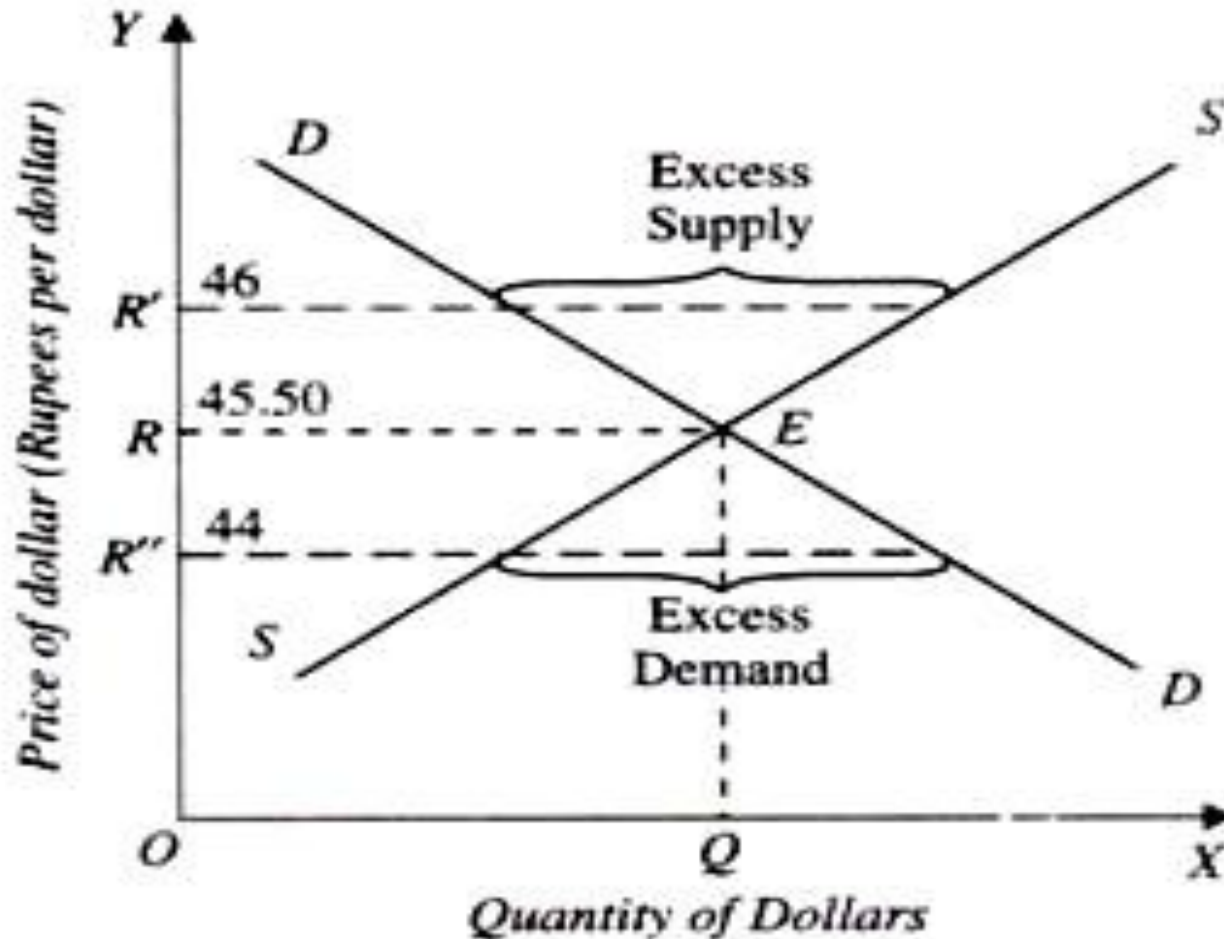
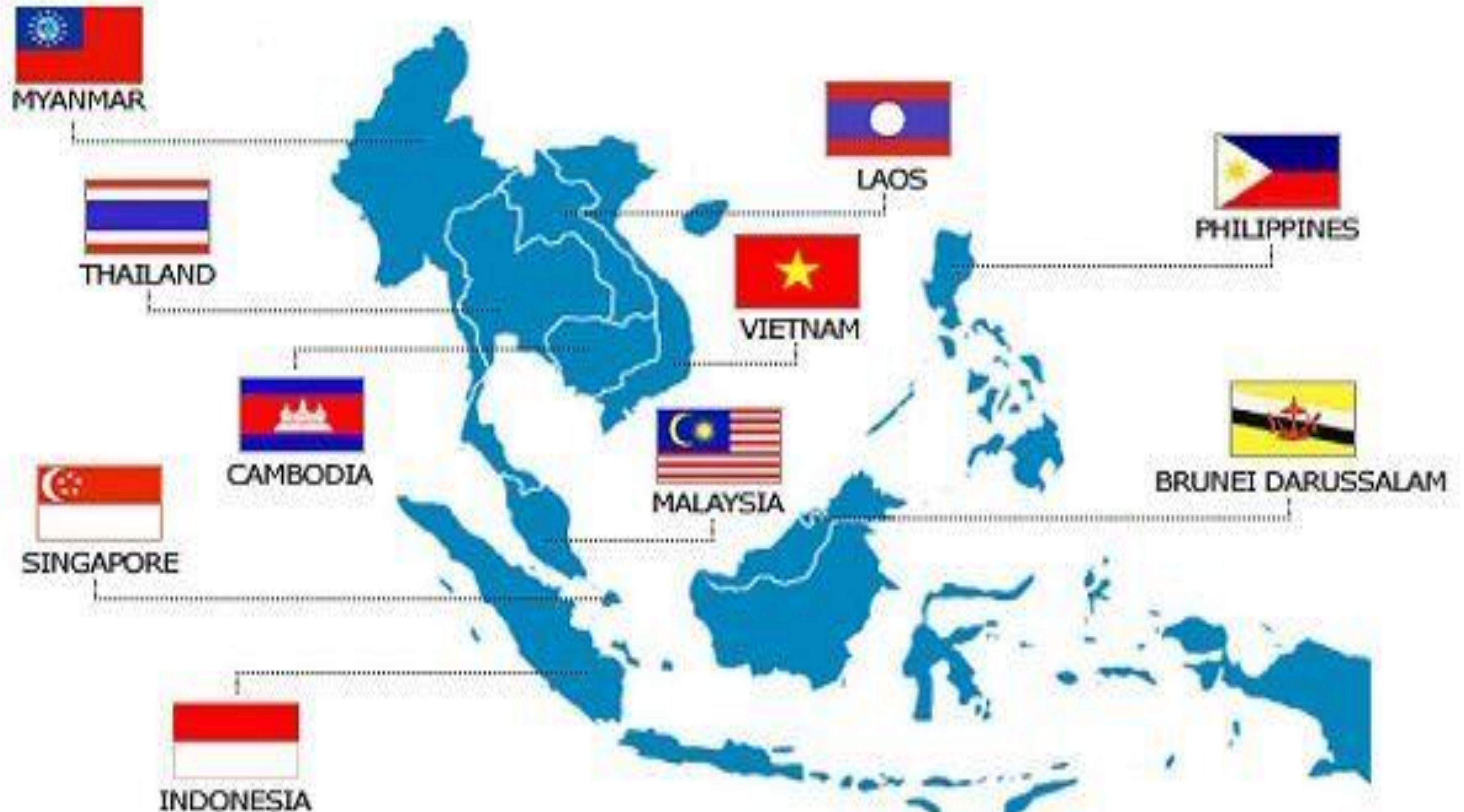


Fig. 35.1. *Determination of Exchange Rate of a Dollar in terms of Rupess*

ASEAN COUNTRIES

- Membership. 10 States — **Brunei Darussalam**, **Cambodia**, **Indonesia**, **Laos**, **Malaysia**, **Myanmar**, **Philippines**, **Singapore**, **Thailand**, and **Vietnam**. 1 Observer – **Papua New Guinea**

ASEAN MAP


ASEAN Member Countries
MYANMAR
LAOS
PHILIPPINES
THAILAND
VIETNAM
CAMBODIA
MALAYSIA
BRUNEI DARUSSALAM
SINGAPORE
INDONESIA

What is the Gold Standard?

- The gold standard is a monetary system where a country's currency or paper money has a value directly linked to gold.
- With the gold standard, countries agreed to convert paper money into a fixed amount of gold.
- A country that uses the gold standard sets a fixed price for gold and buys and sells gold at that price. That fixed price is used to determine the value of the currency.
- For example, if the U.S. sets the price of gold at $500 an ounce, the value of the dollar would be 1/500th of an ounce of gold.

Gold Standard also Mint Parity

- Indian Rupee in terms of Gold = 0.001 gms of gold.
- England's Pound in terms of Gold = 0.1 gms of gold.

Current Exchange Rate:

- Then the exchange rate between Indian rupee and English pound

1 English pound = Rs. (0.1/0.001)

1 English pound = Rs. 100

Revaluation/ Appreciation:

- Then the exchange rate between Indian rupee and English pound

1 English pound = Rs. (0.1/0.01)

1 English pound = Rs. 10

Devaluation/ Depreciation:

- Then the exchange rate between Indian rupee and English pound

1 English pound = Rs. (0.1/0.0001)

1 English pound = Rs. 1000

The above exchange rate is based on gold contents of the respective currencies.

- England 1 pound =113.0016 grains of gold
- USA 1 $ = 23.22 grains of gold

- 1 pound = 4.87 $
- TRANSPORTATION OF GOLD = 3 CENTS
- 4.87- 3 cents= 4.84$ lower limit
- 4.87+3 cents = 4.90 $ upper limit

Working of Gold Standard

- **Gold Point**:The limit till which the price of gold and the exchange rate may vary is called as gold point.Gold point is the cost of shipping gold worth Rs.100 or 1 Pound.
- Gold Point can be of two types :

1. Gold export point : Cost of exporting gold worth Rs. 100 or 1 pound
2. Gold import point: Cost of importing gold worth Rs. 100 or 1 pound

- If the cost of importing and exporting is Rs.5, then the exchange rate can be Rs.105 = 1 Pound = Gold point.
- If the exchange rate is 110 = 1 PoundIf the exchange rate is 95 = 1 Pound, then

Working of Gold Standard

- In accordance with the law of supply and demand, the concept of Gold Point determined the fluctuating limits of currency fixed the cost of money between the place where the bill was drawn and that in where it was payable.

- In the exchanges rates between gold-standard countries, these limits were known as the gold points, for the reason that

if the price of foreign bills rose above the upper limits determined by the exchange rate, countries would find it cheaper to export gold than to export bills for the purpose of settling international accounts.

Conversely, if the exchange rate fell below the lower limit of the determined rate, countries would find it cheaper to import gold than to sell bills to foreign creditors.

Deficit and Surplus in BoP under Gold Standard

Automatic Adjustments in BoP

Price – Specie Flow Mechanism

To keep the exchange rate fixed

The reciept of gold represents the surplus in BoP

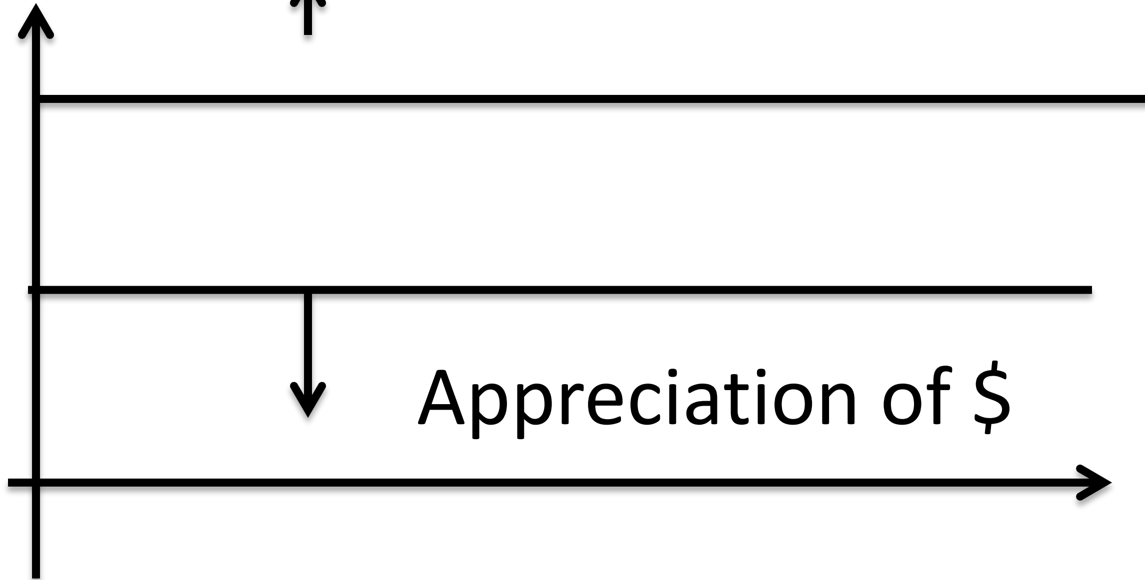
A Country with BoP Surplus :

Receives gold -> Will have its Money ss increased -> Domestic Price will increase ->exports reduce-> Corrects surplus in BoP -> BoP in balance.

The loss of gold represents the deficit in the BoP

A Country with BoP Deficit :

Loss of gold -> Will have its Money ss decreased -> Domestic Price decrease ->exports increase -> corrects deficit in BoP -> BoP in balance.


Depreciation of $
1 Pound= 4.90$
1Pound =4.84$
Appreciation of $