MODULE 43: EXCHANGE RATE POLICY AND MACROECONOMIC POLICY

In-Class Presentation of Module and Sample Lecture

Suggested time: This module can be covered in one hour-long class session.

- **I.** Exchange Rate Policy
  - **A.** Exchange Rate Regimes
  - **B.** How Can an Exchange Rate Be Held Fixed?
  - **C.** The Exchange Rate Regime Dilemma

I. Exchange Rate Policy

As we have seen in the previous module, the nominal exchange rate is a price that is determined by supply and demand in a market. This is very similar to how the price of apples or soybeans might be set by market forces.
However, a nation can deliberately manipulate the exchange rate of its own currency to achieve certain economic goals.

Why? Because the exchange rate has a great deal of influence on net exports. If your nation's currency is inexpensive, foreigners will find your goods to be inexpensive and your net exports will rise.

A. Exchange Rate Regimes

An **exchange rate regime** is a rule governing policy toward the exchange rate.

There are two main kinds of exchange rate regimes:
A country has a **fixed exchange rate** when the government keeps the exchange rate against some other currency at or near a particular target. For example, Hong Kong has an official policy of setting an exchange rate of HK$7.80 per US$1.
A country has a **floating exchange rate** when the government lets the exchange rate go wherever the market takes it. This is the policy followed by Britain, Canada, and the United States.

But if the exchange rate is determined by market forces of supply and demand, how can it be held fixed?

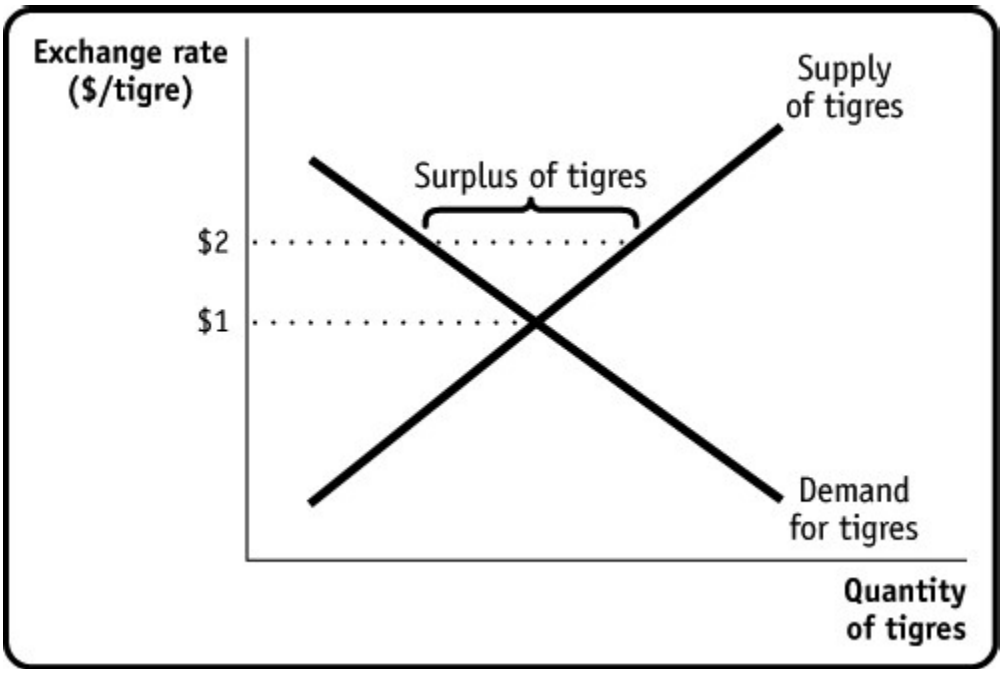
B. How Can an Exchange Rate Be Held Fixed?

Note: the text uses an example of a hypothetical nation of Genovia. It might be interesting if the instructor modified the example by creating a nation that sounds suspiciously similar to a local town or high school.

Suppose the small nation of El Tigardo decides to fix their currency, the tigre, at a rate of $2 US for every 1 tigre.

If the tigre is exchanged in a free market, the equilibrium exchange rate may be higher, or lower, than the target rate of $2.

Scenario 1: the equilibrium exchange rate is below $2.

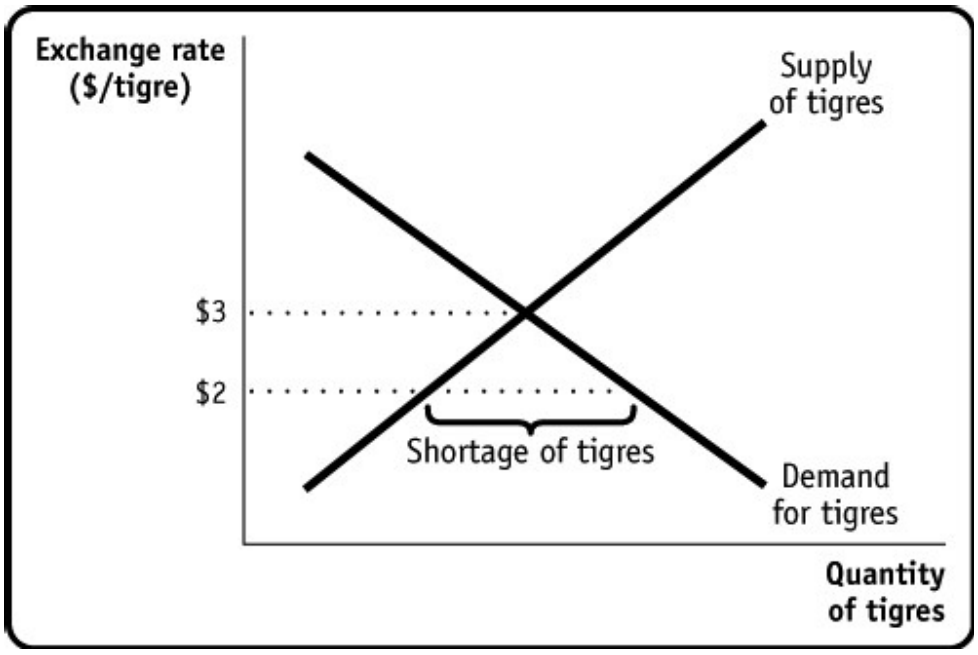


As we know, at the target of $2, there is now a surplus of tigres in the foreign exchange market which would normally push the exchange rate down to $1 per tigre.

The government of El Tigardo can:

- Buy up the surplus of tigres in the foreign exchange market. This is called **exchange market intervention.** The government must have dollars for this purchase, which is why governments keep **foreign exchange reserves**, or stocks of foreign currencies, so that they can engage in these types of price supports.
- The government can try to shift either the demand or supply curves so that the price rises to the target of $2. Maybe the central bank of El Tigardo increases interest rates. This will attract foreign capital investment, increasing the demand for the tigre. This will also reduce the capital outflow from El Tigardo, reducing the supply of tigres. The price of the tigre will begin to rise.
- The government can limit the right of individuals to but foreign currency. The government might require citizens to acquire a license to purchase dollars, thus reducing the supply of the tigre. The price will begin to rise.

Scenario 2: the equilibrium exchange rate is above $2.



As we know, at the target of $2, there is now a shortage of tigres in the foreign exchange market which would normally push the exchange rate up to $3 per tigre.

The government of El Tigardo can:

- Sell tigres in the foreign exchange market.
- The central bank of El Tigardo decreases interest rates. This will deter foreign capital investment, decreasing the demand for the tigre. This will also increase the capital outflow from El Tigardo, increasing the supply of tigres. The price of the tigre will begin to fall.
- The government can limit the ability of foreigners to buy the tigre. The price will begin to fall.

But is it actually a good idea to fix the exchange rate?

C. The Exchange Rate Regime Dilemma

There are advantages and disadvantages of both the fixed and floating exchange rate regimes.

Advantages in Stability

A fixed exchange rate provides stability in foreign transactions in much the same way we experience transactions across state lines. If you take your dollars from Indiana to Kentucky, you know that the value of your dollars is unchanged. But if you take your dollars from Indiana to Europe, the value of those dollars can change daily. A fixed exchange rate avoids this uncertainty.

The fixed exchange rate also commits the central bank to monetary policies that would not upset the exchange rate. For example, if the bank adhered to the exchange rate regime, the bank could not dramatically increase the money supply. This would cause inflation and reduce the value of the currency. More stability.

Disadvantages in Costs

To stabilize an exchange rate through intervention, a country must keep large quantities of foreign currency on hand, and that currency is usually a low-return investment. Even large reserves can be quickly exhausted when there are large capital flows out of a country. If a country chooses to stabilize an exchange rate by adjusting monetary policy rather than through intervention, it must divert monetary policy from other goals, notably stabilizing the economy and managing the inflation rate.

Finally, foreign exchange controls, like import quotas and tariffs, distort incentives for importing and exporting goods and services. They can also create substantial costs in terms of red tape and corruption.