Econ 340

Lecture 14
Pegging the Exchange Rate

Lecture 14 Outline: Pegging the Exchange Rate

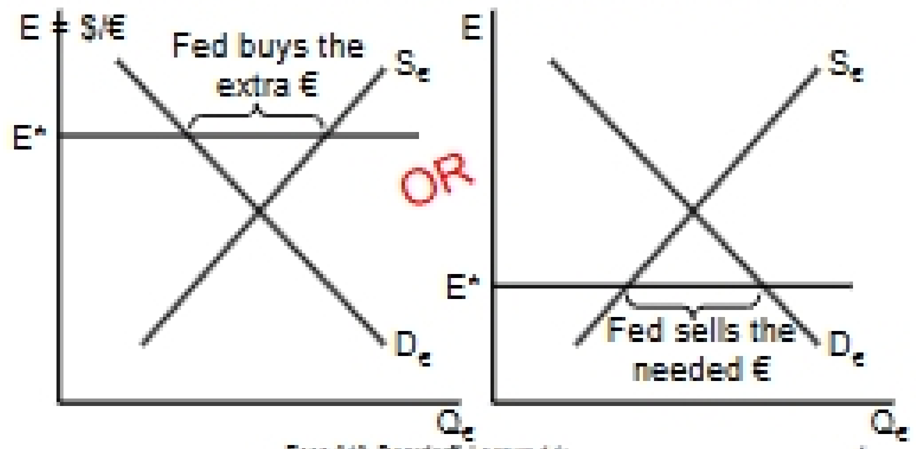
- How It's Done
  - Market Intervention
  - Bands of Fluctuation
  - Hybrids of Pegged and Floating
- Who Pegs?
- Mechanics of Intervention
  - Reserves
  - Money Supply
  - Sterilization
- Effects of Pegging

How It's Done

- What "Pegging" Means
  - To "fix" the exchange rate by intervening in the market
  - It does not mean just fixing it by law – making it illegal to exchange the currency at other than the official rate
    - Countries do that too, but that is not pegging, and it does not entirely work: gives rise to "black market"
  - "Intervention" means
    - Buying or selling foreign currency, so as to
    - Make up the difference between the market's supply and demand
    - Normally done by the pegging country's central bank

How It's Done

- Example: If the Fed were to peg the \$ to the € at rate E* (Note: it does <u>not</u> do this!)



How It's Done

- What "Pegging" Means
  - In practice, pegs are never exact
  - Central banks
    - Set a "par value" (= "central value")
    - Intervene only if rate moves some distance (e.g., 1%) above or below this par value
    - This range of movement is called an "exchange rate band"
  - We will ignore this complication in drawing the market, and pretend that they peg the rate exactly

How It's Done

- Hybrids of Pegged and Freely Floating Exchange Rates
  - Managed Float
    - Intervene to influence the rate
    - But do <u>not</u> announce a target rate or par value
    - And do not necessarily keep the rate constant
  - "Dirty Float" = same as Managed Float

How It's Done

- Hybrids of Pegged and Freely Floating Exchange Rates
  - "Leaning Against the Wind"
    - Particular form of managed float that
      - Does not try to alter the level of the exchange rate, but
      - Does try to slow its rate of change
    - Purpose: to dampen fluctuations

How It's Done

- Hybrids of Pegged and Freely Floating Exchange Rates
  - Crawling Peg
    - A pegged rate with a par value that moves
      - Slowly, and
      - Predictably
    - Example: Country might announce that the par value will appreciate by 0.01% each week as long as central bank is buying foreign exchange, and vice versa

Note: All of these hybrids still do require intervention in the exchange market

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