FIXED EXCHANGE RATES

1. How the central bank fixes the rate:

Assets	**Liabilities**
Bonds	Money
Foreign reserves	

The CB buys or sells foreign reserves to keep the price - the exchange rate - within a band, usually a couple of percent wide. This is *exchange market intervention*

For example, suppose currency is depreciating. CB might sell FX (foreign exchange!), to keep its price down:

Assets	**Liabilities**
Bonds	Money -100
Foreign reserves -100	

2. Some terminology:

CBs often try to prevent their FX operations from directly affecting the money supply. They do this by *sterilizing*, making an offsetting purchase or sale of bonds:

Assets	**Liabilities**
Bonds +100	Money -100 +100
Foreign reserves -100	

But in practice *sterilized intervention* is not very effective, so in the end money supply is usually altered to support exchange rate.

3. Macroeconomics under fixed rate: Because exchange rate is not expected to change, interest rate must equal foreign rate, and money supply adjusts to money demand

Fixed exchange rate => no independent monetary policy

FOREIGN EXCHANGE “REGIMES”

Floating rates

Fixed exchange rates:

Gold standard
Bretton Woods system (1944-71/3)
European Monetary System (1979-1998)
Currency boards (Argentina, Hong Kong)

Other schemes:

Crawling peg (Brazil)
Common currency (EMU)

The dilemma: Countries generally want stable exchange rates; they also generally want independent monetary policy. They can’t have both.