

## Fixed Exchange Rates

(lecture outline)

- unsterilized forex market intervention
  - unsterilized intervention changes monetary base
- sterilized forex market intervention under *perfect* asset substitubility
  - if domestic and foreign assets are perfect substitutes sterilized intervention can not affect nominal exchange rates
- sterilized forex market intervention under *imperfect* asset substitubility
  - if changes in composition of commercial banks' assets changes risk premium on domestic assets, sterilized intervention can affect nominal exchange rate and keep monetary base constant
- monetary policy - ineffective under fixed exchange rate regime
- fiscal policy - fixed rates regime reinforces fiscal policy
- practical issues
  - are fixed rates technically feasible?
    - \* fixed rates are subject to speculative attacks
    - \* many countries have sufficient reserves to exchange the entire monetary base into foreign exchange, the problem is that the cost of shrinking monetary base and money supply is too high
  - announce or not?
    - \* announcement provides nominal anchor
  - fix at what level?
    - \* rer in equilibrium
    - \* crawling peg is a regime with fixed rate of depreciation  $\bar{\epsilon} = \pi^{desired} - \pi^{foreign}$
  - which currency?
    - \* price stability vs. reer stability
  - should there be a band?
    - \* self-enforcing
    - \* monetary autonomy within the band
  - should there be a currency board?
    - \* monetary base can be issued only if there is a corresponding increase in forex reserves
    - \* benefits: credibility, transparency, confidence
    - \* costs: no room for autonomous monetary policy (even if domestic and foreign assets are imperfect substitutes), no room for lender of the last resort