LECTURE TEN - PART SIX

Today's Hybrid System

- Today's exchange rate system fits into no mold.
- The world has moved to a managed float.

#1: Floating Exchange Rates

- Countries like the United States have a primarily flexible or "floating" exchange rate.
- Markets determine the currency's value.
- There is very little intervention.

#2: Managed Flexible Exchange Rates

- Other countries have managed flexible exchange rates.
- Managed Float: A country buys or sells its currency to reduce day-to-day volatility of currency fluctuations.
- A country may also engage in systematic intervention to move its currency toward what it believes to be a more appropriate level.

#3: Pegged Currencies

- Many countries peg their currencies to a major currency or to a "basket" of currencies.
- Sometimes the peg is allowed to glide smoothly upward or downward in a system known as a gliding or crawling peg.

#4: Currency Blocs Like the Euro

- Some countries join together in a currency bloc in order to stabilize exchange rates amongst themselves.
- These countries then allow their single currency to float flexibly relative to those of the rest of the world.
- The most important of these blocs is the European Union which, in 1999, moved to a single currency -- the "Euro".

#5: Monetary Intervention

Key Point
Almost all countries tend to intervene either when markets become “disorderly” or when exchange rates seem far out of line with existing price levels and trade flows.

Government Exchange Rate Intervention

- A government buys or sells its own currency, or foreign currencies, to affect exchange rates.
- Example: The Japanese government might buy $1 billion worth of Japanese yen with U.S. dollars.
- This would cause an appreciation or rise in value of the yen.

Key Concept
A government intervenes when it believes its foreign exchange rate is out of line with its currency’s fundamental value.

An Historical Example

- In 1987, the then "G-7" nations were the U.S., Germany, Japan, Britain, France, Italy, and Canada.
- They agreed to stabilize the value of the U.S. dollar relative to the other countries' currencies.

The Problem

- During the previous 2 years, the dollar had declined rapidly because of large U.S. trade deficits.
- The G-7 nations other than the U.S. worried that further weakening of the dollar would stifle their exports and disrupt growth.
- These nations agreed to purchase large amounts of dollars to boost the dollar's value.