

13.1: Overview of Fixed Exchange Rates

Learning Objective

1. Preview the discussion about fixed exchange rate systems, their varieties, and their mechanisms.

This chapter begins by defining several types of fixed exchange rate systems, including the gold standard, the reserve currency standard, and the gold exchange standard. The **price-specie flow mechanism** is described for the gold standard. It continues with other modern fixed exchange variations such as fixing a currency to a basket of several other currencies, crawling pegs, fixing within a band or range of exchange rates, currency boards, and finally the most extreme way to fix a currency: adopting another country's currency as your own, as is done with **dollarization** or euroization.

The chapter proceeds with the basic mechanics of a **reserve currency standard** in which a country fixes its currency to another's. In general, a country's central bank must intervene in the foreign exchange (Forex) markets, buying foreign currency whenever there is excess supply (resulting in a **balance of payments surplus**) and selling foreign currency whenever there is excess demand (resulting in a **balance of payments deficit**). These actions will achieve the fixed exchange rate version of the interest parity condition in which interest rates are equalized across countries. However, to make central bank actions possible, a country will need to hold a stock of foreign exchange reserves. If a country's central bank does not intervene in the Forex in a fixed exchange system, black markets are shown to be a likely consequence.

Results

- **Gold standard** rules: (1) fix currency to a weight of gold; (2) central bank freely exchanges gold for currency with public.
- Adjustment under a gold standard involves the flow of gold between countries, resulting in equalization of prices satisfying purchasing power parity (PPP) and/or equalization of rates of return on assets satisfying interest rate parity (IRP) at the current fixed exchange rate.
- Reserve currency rules: (1) fix currency to another currency, known as the reserve currency; (2) central bank must hold a stock of foreign exchange reserves to facilitate Forex interventions.
- Gold-exchange standard rules: (1) reserve country fixes its currency to a weight of gold, (2) all other countries fix their currencies to the reserve, (3) reserve central bank freely exchanges gold for currency with other central banks, (4) nonreserve countries hold a stock of the reserve currency to facilitate intervention in the Forex.
- The post-World War II fixed exchange rate system, known as the Bretton Woods system, was a gold exchange standard.
- Some countries fix their currencies to a weighted average of several other currencies, called a "basket of currencies."
- Some countries implement a crawling peg in which the fixed exchange rate is adjusted regularly.
- Some countries set a central exchange rate and allow free floating within a predefined range or band.
- Some countries implement currency boards to legally mandate Forex interventions.
- Some countries simply adopt another country's currency, as with dollarization, or choose a brand-new currency, as with the euro.
- The interest rate parity condition becomes the equalization of interest rates between two countries in a fixed exchange rate system.
- A balance of payments surplus (deficit) arises when the central bank buys (sells) foreign reserves on the Forex in exchange for its own currency.
- A black market in currency trade arises when there is unsatisfied excess demand or supply of foreign currency in exchange for domestic currency on the Forex.

key takeaway

- See the main results previewed above.

exercise

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is "a tax on imports," then the correct question is "What is a tariff?"
 - The term for the currency standard that fixes its circulating currency to a quantity of gold.

- The term for the currency standard in which a reserve currency is fixed to a quantity of gold while all other currencies are fixed to the reserve currency.
- The currency standard used during the post–World War II Bretton Woods era.
- The term describing the deficits and surpluses run by a country to maintain a fixed exchange rate.
- The term used to describe a decision by another country to adopt the U.S. dollar as its currency.
- The nonintervention in the Forex market by a country's central bank is likely to lead to the development of these kinds of market activities.

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