Econ 340

Lecture 14
Pegging the Exchange Rate

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

Example: If the Fed were to peg the $ to the € at rate $E^*$ (Note: it does not do this!)

Fed buys the extra €
Fed sells the needed €

How It’s Done

• Hybrids of Pegged and Freely Floating Exchange Rates
  – Managed Float
    • Intervene to influence the rate
    • But do not 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

- 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

The Gold Standard

- Common in 19th century, but ended 1914.
- Countries
  - Defined their currencies in terms of gold
  - Stood ready to buy and sell gold at their official rate
- Result was like pegged exchange rates, except that
  the pegging was to gold.
- "Rules" of the Gold Standard
  - Fix currency price of gold
  - Keep money supply equal gold supply (or proportional to it)
  - Be ready to redeem currency in terms of gold and allow gold
    (and thus money) to flow internationally
- Implication of the gold standard: Changes in money
  supply equilibrate the markets

Who Pegs?

- US?
  - No
  - But we did have a pegged exchange rate until
    1973
    - ( Strictly speaking, it was other countries that
      pegged to us, not us to them)
    - In fact, from the late 1940s until 1973, virtually all
      countries pegged to the US dollar (exceptions
      were Canada, which sometimes floated, and
      several former colonies that pegged to the British
      pound or French franc)

- Europe?
  - No: the euro floats freely
  - Before the euro, but after 1973,
    - Countries did not peg to currencies outside Europe
    - But they often did try to peg to each other
  - Denmark now pegs to the euro
  - Other EU countries outside the euro (UK,
    Sweden) and countries outside the EU
    (Switzerland, Norway) all have floating exchange rates

Who Pegs?
Who Pegs?

• Other Developed Countries?
  – No: Canada, Japan, Australia, New Zealand, Korea all have floating rates

Who Pegs?

• Developing Countries?
  – They are mixed
  – A sample (from IMF, 2008):
    • Argentina: pegged (to US dollar)
    • Brazil: float
    • Bulgaria: currency board (pegged to euro)
    • China pegged to dollar until summer 05 and July 08 to July 2010; now sometimes says it pegs to basket of currencies
    • Costa Rica: crawling peg
    • India: managed float
    • Egypt: managed float
    • Nepal: pegged (to India’s rupee)
  – We’ll update this list in a later lecture.

Lecture 14 Outline:
Pegging the Exchange Rate

• How It’s Done
  – Market Intervention
  – Bands of Fluctuation
  – Hybrids of Pegged and Floating
  – The Gold Standard
• Who Pegs?
• Mechanics of Intervention
  – Reserves
  – Money Supply
  – Sterilization
• Effects of Pegging
• Chinese Currency Manipulation

Mechanics of Intervention

• Change in Central Bank’s Reserves of Foreign Currency
  – What they buy is added to reserves
  – What they sell is subtracted from reserves

• Always: Buy or sell foreign currency in exchange for domestic currency
• This has two effects, if nothing else is done:
  1. Changes the level of reserves of foreign currency
  2. Changes the level of the country’s own domestic money supply in circulation

• Change in Country’s Domestic Money Supply
  – When US Central Bank (CB) buys € with $, those $ go into circulation
    • This adds to the US money supply
    • (Actually, it adds even more, due to “money multiplier” you learned about in Econ 102)
  – When CB sells € for $, those $ come out of circulation
    • Reducing the money supply
    • Similar to Gold Standard
Mechanics of Intervention

- **Sterilization**
  - However, Central Bank has the option of preventing this change in the money supply by “sterilization”
  - Sterilization = Use of offsetting open market operations to keep the money supply unchanged
  - Example: To sterilize a $1 m. purchase of foreign currency, CB would sell $1 m.-worth of bonds
    - This takes the $1 m. back out of circulation
  - Sterilization is a policy choice
    - Central Bank can do it, or not, as it sees fit
    - Some central banks say they lack the tools to sterilize
    - Most, if they intervene in the exchange market, do it, thus preventing gold-standard-like adjustment

Effects of Pegging

- **Case I: Dollar Over-valued**
  - In this case (unlike PPP), “overvalued” means the dollar is being pegged at a rate that is above (i.e., appreciated relative to) the market-clearing rate
    - Which means that the actual exchange rate, E, the price of foreign currency, is below the market-clearing rate, $E_0$
  - At the overvalued exchange rate, there is excess demand for foreign currency, which CB must provide by selling out of reserves. Thus reserves fall.
    - If it does not sterilize, then the money supply also shrinks
    - If it does sterilize, then it buys bonds

Effects of Pegging

- **Case II: Dollar Under-valued**
  - In this case, “undervalued” means the dollar is being pegged at a rate that is below (i.e., depreciated relative to) the market-clearing rate
    - Which means that E, the price of foreign currency, is above the market-clearing rate, $E_0$
  - At undervalued rate, there is excess supply of foreign currency, which CB must take out of the market by buying and adding to reserves.
    - If it does not sterilize, then the money supply grows
    - If it does sterilize, then it sells bonds
Effects of Pegging

- Peg if $ Undervalued

\[ E = \frac{\$}{\text{€}} \]

Fed buys € with $, $ Undervalued:
- Reserves (of €) rise
- If intervention is not sterilized, money supply (of $) rises.

Effects of Pegging

- Further implication of an undervalued peg
  - Nothing critically important
  - If it continues, Central Bank piles up more and more reserves, but there is no limit on its ability to do that
  - Result: No crisis
  - However, if it does not sterilize, then money supply grows too, and this may cause inflation.

Effects of Pegging

- Note the asymmetry:
  - Overvalued peg leads to crisis
  - Undervalued peg does not

Example of Undervalued Peg: China

Global Imbalances Reflected in Growth of Reserves

- $ Money supply, % change year ago (R)
- Foreign exchange reserves, billions of U.S. dollars (L)

A Special Case: The US Dollar

- Most countries that peg their currencies, peg them to the US dollar
- That means that their reserves are dollar-denominated assets, mostly US govt’s bonds
- If they keep their currencies undervalued, then that means the dollar is overvalued
  - But the overvalued dollar need not lead to crisis
  - Others want, need, or at least choose, to hold our dollars

A Special Case: The US Dollar (see Ferguson)

- Most of US foreign borrowing is being met by foreign central banks
- That means they are holding reserves, a result of buying dollars to
  - Keep their currency down
  - Keep the US dollar up
- We benefit from the high dollar: we can buy cheap goods and services
- But we borrow in dollars in order to do it
  - If others were to stop lending, then the dollar would fall and so would the value of our debt
  - Thus it is "their problem," not ours!
Effects of Pegging

- A Special Case: The US Dollar vs Chinese Renminbi (see Levy)
  - Many US policymakers disagree: Thus US has pressured China to appreciate the yuan
    - Why? To make it easier to sell US goods
    - Congress threatens trade barriers against China
      - Might have once been legal under Section 421, special “China safeguard” negotiated with China’s WTO accession, but that has now expired.

Levy argues
- Tariffs against China won’t work
  - We’ll just switch to importing from other low-cost countries
  - US trade deficit (due to our low saving) will be unchanged
- To really have an effect and send a message, we should: Reduce government spending!

China’s Exchange Rate, US$/Yuan, 2000-2016

The exchange rate did not change at all between 2000 and 2005.

China’s Reserves, $ trillions, 2000-2016

And reserves more than quadrupled!

Effects of Pegging

- A Special Case: The US Dollar vs Chinese Renminbi
  - It is clear from the two graphs that
    - China was pegging their currency to the US dollar in 2000-2005
    - To do so they were buying dollars and thus accumulating almost $1 trillion of reserves

Example: To see the effects of pegging versus floating,
- Consider the Chinese foreign exchange market (for $)
- Suppose the US economy expands, increasing US imports from China.
- What will happen if
  - The renminbi floats?
    Or, instead, if
  - The renminbi is pegged to the US dollar?
Effects of US Expansion on China if Renminbi is Floating

- US expansion if renminbi is floating

\[ E = \frac{\text{¥}}{\text{S}} \]

Effects of US expansion:
- \( S \) shifts right (more US imports from China)
- Yuan appreciates (\( \text{¥}/\text{S} \) falls)
- No change in China’s reserves or money supply
- Rising ¥ reduces US imports and increases US exports

Effects of US Expansion on China if Renminbi is Pegged

- US expansion if renminbi is pegged

\[ E = \frac{\text{¥}}{\text{S}} \]

Effects of US expansion:
- \( S \) shifts right (more US imports from China)
- Yuan stays constant (no further effect on US trade)
- People’s Bank of China buys more $ • Reserves rise faster • Money supply expands faster if not sterilized • May cause inflation in China

Effects of Pegging

- Implication of Example:
  - Something always changes in the exchange market when changes occur for trade, capital flows, or other transactions
  - Exchange rate changes if floating
  - Reserves (and maybe money supply) change if pegged

Lecture 14 Outline: Pegging the Exchange Rate

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  - Bands of Fluctuation
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- Who Pegs?
- Mechanics of Intervention
  - Reserves
  - Money Supply
  - Sterilization
- Effects of Pegging
- Chinese Currency Manipulation

Chinese Currency Manipulation

- We saw in the graphs above that China was intervening in 2000-2005 to keep the value of its currency down
- This led policy makers in the US to complain, and in 2005 China let its currency rise

China’s Exchange Rate, US$/Yuan, 2000-2016

The yuan appreciated steadily between 2005 and 2008
Chinese Currency Manipulation

• But China’s reserves continued to rise, indicating that it was still buying dollars.

Reserves have mostly risen since 2008, to over $4 trillion.

China’s Reserves, $ trillions, 2000-2016

China’s Exchange Rate, US$/Yuan, 2000-2016

The yuan stopped rising in 2008, then rose slowly.

Chinese Currency Manipulation

• The financial crisis of 2008 slowed down both
  – The appreciation of the renminbi, and
  – The growth of reserves

• The financial crisis of 2008
  – Slowed down the appreciation of the renminbi, off and on
  – But reserves continued to grow rapidly in most periods until 2014
  – China’s purchases of US dollars were still holding down the yuan’s value, or slowing its rise

• But all that changed in 2014

Reserves continued to rise, to almost $2 trillion.

Reserves have mostly risen since 2008, to over $4 trillion.

China’s Reserves, $ trillions, 2000-2016

China’s Exchange Rate, US$/Yuan, 2000-2016

The yuan stopped rising in 2008, then rose slowly.
China’s Exchange Rate, US$/Yuan, 2000-2016

The yuan reached its peak in 2013, and began to fall in 2015.

China's Reserves, $ trillions, 2000-2016

From 2014, China’s reserves have been falling.

Chinese Currency Manipulation

- Conclusion:
  - China did intervene extensively 2000-2014,
    - Sometimes to keep the yuan from moving,
    - Other times to slow its rise
  - But since then,
    - Although the yuan has been falling in value,
    - This was in spite of Chinese intervention, not because of it
    - They have sold close to $1 trillion of reserves, slowing its fall (over $1 trillion as of March 2017)

Chinese Currency Manipulation

- See Varas
  - Varas notes that China fixed its exchange rate from 1995 to 2005, consistent with the graph above
  - But she also shows the following graph, which shows it
    - Moving first up, then down, in 2000-2005
    - Then rising steadily ever since, except for
      - A big drop after the 2008 crisis
      - And a smaller drop in 2015
Chinese Currency Manipulation

• Why does Varas disagree with my graphs?
  – Hers is the “Real Broad Effective Exchange Rate”
  – Since the renminbi was pegged to the US dollar 2000-2005, it rose and fell with the dollar relative to other currencies
• See the Graph of the Trade-Weighted Dollar from the last lecture

Chinese Currency Manipulation

• Conclusion from both Varas and these graphs:
  – China did manage its exchange rate and limited its appreciation until recently
  – Since early 2015, China has acted to raise its currency’s value, not lower it
  – It has not, throughout this time span, ever acted deliberately to depreciate the yuan
  – Therefore China has not been a currency manipulator

Next Time

• International Macroeconomics
  – Macro Effects ON the Exchange Market
  – Macro Effects OF the Exchange Market
  – Macro Effects THROUGH the Exchange Market