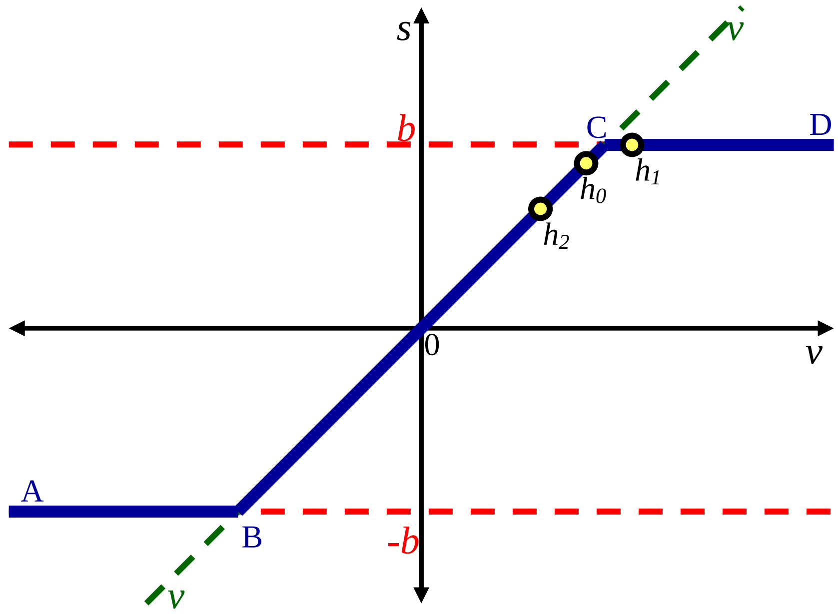
Chapter 28 Fixed Exchange Rates and Target Zones

Question 28.4

Figure 28.10, which is reproduced below, highlights the workings of the target zone model. Suppose that a country has a freely floating exchange rate. The dashed line, crossing the origin, represents movement of the exchange rate s in response to changes in fundamentals v.

Figure 28.10



28.4A What are fundamentals that can change v? Which variables can be changed by the authorities to influence v?

28.4B What is the expected change in the exchange rate, anywhere on the dashed line v, such as points h_o and h_2?

Suppose now that the government introduces a target zone.

28.4C What is the expected exchange rate change at point h_o? Is this a feasible outcome in a fully credible target zone model?

28.4D Does it make sense for the government to announce its intentions when it wants to introduce the zone?

Question 28.5

The target zone model does not hold up very well empirically. Furthermore, many exchange rate targeting countries do not explicitly announce their targets. Rather, they pursue an exchange rate intervention policy called "leaning against the wind". This means that for some deviation from the target exchange rate (a fixed number), the authorities will intervene, but not to the full extent of the deviation. For example, if the target of exchange rate fundamentals is v=0, then the authorities could follow the decision rule like $\Delta v_t = -\alpha v_{t-1}$, for $0 < \alpha < 1$. Here α measures the extent of the authorities reaction.

28.5A Draw a figure as figure 28.11, including the free float line, the target zone s-shape.

28.5B What impact does the amount of volatility have on size of the honeymoon effect? Explain.

28.5C Now add a "leaning against the wind" exchange rate line.

28.5D How do the "leaning against the wind" and target zone model compare in terms of reducing volatility and the honeymoon effect?

28.5E What does this conclusion imply for policymakers?

Question 28.6

Chapter 28 highlights many obstacles for countries that pursue a fixed exchange rate policy. Yet, many countries seek to maintain some fixed exchange rate regime.

28.6A What are the benefits of a fixed exchange rate regime?

28.6B Why are there so many typologies of exchange rate regimes in between a fully free float and a fully fixed exchange rate?

Many countries that have a history of high inflation seek to reduce it by pegging their currency to that of another country with a history of low inflation.

28.6C Which credibility problems does such a country face when it pegs its exchange rate?

28.6D Can you think of policy measures that would build such credibility?

28.6E Are the same inflation-unemployment preferences enough for a country to successfully maintain a fixed exchange rate? Explain.