

# DOWNLOAD PDF EFFECTIVE EXCHANGE RATE CLASSIFICATIONS AND GROWTH

## Chapter 1 : The Fed - Recoveries and Trade: Does the Exchange Rate Regime Matter?

*An 'effective' de facto exchange rate regime classification is then obtained by assigning country-year observations to the regime with the highest predictive probability obtained from the estimation problem.*

A summary for understanding exchange rates. Factors that affect exchange rates and the impact of exchange rates on the economy. Buying goods from America becomes more expensive. It is cheaper for Americans to buy UK goods, so the quantity of exports should increase. UK inflation will increase. Imported goods are more expensive cost push inflation. Also, British goods are more attractive causing a rise in demand demand pull inflation Summary of depreciation A depreciation in exchange rate makes exports more competitive and imports more expensive A depreciation helps UK exporters and improves UK growth prospects, but causes higher prices and inflation. Effects of appreciation The effects of an appreciation in Sterling will lead to the opposite. A higher value of sterling makes US imports cheaper for British consumers, but, UK exports become more expensive. An appreciation in the exchange rate will tend to reduce aggregate demand assuming demand is relatively elastic Because exports will fall and imports increase. An appreciation is likely to worsen the current account assuming Marshall Lerner condition and demand is relatively elastic An appreciation is likely to reduce inflation because: Import prices are lower Firms have more incentives to cut costs. Is it good or bad to have a devaluation in the exchange rate? A falling exchange rate can be beneficial if the economy is uncompetitive and stuck in a recession. A devaluation helps to increased demand for exports and create jobs. In a recession, inflation is unlikely to be a problem. However, in a boom, a devaluation could lead to inflation. Also, a devaluation does reduce living standards as imports become more expensive. An appreciation in the exchange rate is beneficial if it is caused by the economy becoming more productive and competitive. However, if there is an appreciation due to speculation, then it could be harmful as exporters will not be able to compete. The Swiss intervened to prevent the Swiss France becoming too strong in recent Euro crisis. An exchange rate is determined by the supply and demand for the currency. If there was greater demand for Pound Sterling, it would cause the value to increase. An appreciation in the exchange rate could occur if the UK has: Higher interest rates make it more attractive to save in the UK, therefore more investors will switch to British banks. Therefore the value of the pound will increase. If British goods become more competitive, there will be greater demand causing the value to increase. A current account surplus means the value of exports of goods and services is greater than imports. This demand for UK goods tends to cause stronger exchange rate. Fixed Exchange Rate This occurs when the government intervenes to try and keep the value of the currency at a certain level against other currencies. For example, in , the UK joined the Exchange Rate Mechanism where the value of Pound was supposed to keep within a certain target band against D-Mark. Exchange Rate Mechanism Crisis Advantages and disadvantages of fixed exchange rates Currency Manipulation Some countries are not part of an official exchange rate mechanism, but they may still to try influence their currency. For example, China has sought to keep the value of their currency undervalued by buying US assets. The motive for keeping exchange rate undervalued is that exports become more competitive leading to higher growth. The idea is to eliminate exchange rate fluctuations. However, the Euro has run into several problems. In particular, uncompetitive countries are no longer able to devalue to restore competitiveness.

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## Chapter 2 : Real effective exchange rate | Economics Help

*Effective Exchange Rate Classifications and Growth Justin M. Dubas University of Notre Dame Byung-Joo Lee University of Notre Dame Nelson C. Mark University of Notre Dame and NBER.*

The real effective exchange rate measures the value of a currency against a basket of other currencies; it takes into account changes in relative prices and shows what can actually be bought. Sterling effective exchange rate index. Nominal exchange rate The nominal exchange rate measures the current value of a currency against another. This is usually trade-weighted. When looking at the effective Sterling exchange rate, we will compare the value of Sterling against our main trading partners – The Euro, the Dollar, the Yen etc. A weighting will be given to different trading countries depending on how significant they are. The effective exchange rate is good for looking at the overall performance of a currency. For example, the Pound may appreciate against the Dollar – but this may be due to just temporary weakness in the Dollar. However, if the overall effective exchange rate increases, it suggests the Pound is becoming stronger. Real exchange rate The real exchange rate measures the value of currencies, taking into account changes in the price level. The real exchange rate shows what you can actually buy. It is the value consumers will actually pay for a good. An increase in the real exchange rate means people in a country can get more foreign goods for an equivalent amount of domestic goods. Therefore an increase in the real exchange rate will tend to increase net imports. Foreigners will buy our less expensive exports. It now becomes more attractive to buy imports. This can cause a widening of the current account deficit and lower domestic AD. It will also help reduce inflation. Similarly, a fall in the real exchange rate should increase net exports as domestic goods are more competitive. Does an increase in Real Effective Exchange Rate increase or decrease international competitiveness for the country? An increase in the real effective exchange rate will decrease international competitiveness. In this case, the real exchange rate would stay the same. Example of Real exchange rate Suppose there is just one good that is traded. The real exchange rate is 1: Then the real exchange rate is the same as the nominal exchange rate. There is perfect purchasing power parity PPP. It makes no difference whether you buy the good in the US or UK. Now suppose that the cost of British goods increases. This means that the good in terms of Pound is 1. Therefore, we would expect the nominal exchange rate to adjust to reflect the real changes. If goods in the UK are more expensive, we would expect the Pound Sterling to fall in relation to the dollar. In theory, the nominal exchange rate should reflect the real exchange rate. In the real world, there are numerous goods, so that we used average price indexes to indicate relative movement in the price of goods. Changes in real exchange rate If a country experiences rapid productivity growth, then it can enable lower costs and lower price level, this will help to reduce the real exchange rate. Misaligned real exchange rates Suppose that prices in country A increase, this decreases the real exchange rate. This tried to keep the value of the Pound at a fixed rate against the German D-Mark. However, in the late 1970s, the UK experience high inflation and then a recession. The market value of the Pound started to fall, to reflect the real changes in the exchange rate. However, the government rather artificially were trying to keep the value of the Pound high and constant in the ERM. Therefore, they intervened in the foreign exchange markets buying Pounds and increasing interest rates to keep the value of the Pound high. Therefore, the nominal exchange rate became overvalued against the real exchange rate. But, eventually, the attempt to keep the nominal value of the Pound high failed. Markets correctly predicted that the Pound was overvalued. Intense selling of the Pound eventually forced the UK government to leave the ERM and allow the Pound to devalue – coming closer to its real exchange rate. This was an example of the nominal exchange rate is overvalued compared to its real value.

## Chapter 3 : Understanding exchange rates | Economics Help

*Abstract. We propose an econometric procedure for obtaining de facto exchange rate regime classifications which we apply to study the relationship between exchange rate regimes and economic growth.*

When banks and non-banks have foreign currency liabilities, an exchange rate depreciation has valuation effects that can lead to a tightening in domestic financial conditions. Using trade-weighted exchange rates and new BIS-constructed debt-weighted exchange rates to separate these influences, this article finds that the financial channel partly offsets the trade channel for emerging market economies but the effect is weaker for advanced economies. F31, F41, F43, G The trade channel, or demand substitution channel, underpins the effect of the exchange rate on economic activity. An exchange rate appreciation raises the international cost of exports, reducing both export demand and the domestic cost of imports, leading to substitution away from domestic production. Thus, an appreciation is contractionary for domestic economic activity, while a depreciation is expansionary. However, the links between economies go beyond trade. Extensive financial connections, and in particular the large stock of foreign currency borrowing, provide another crucial means by which external conditions can affect an economy. An appreciation of the local currency can strengthen the balance sheets of domestic borrowers in foreign currency, easing domestic financial conditions. This "financial channel" of exchange rates can act as a potential offset to the trade channel, in that an exchange rate appreciation boosts domestic economic activity through easier financial conditions. Conversely, a depreciation could negatively affect the economy by weakening domestic balance sheets. In this article we use the term financial channel interchangeably with "risk-taking channel", which is also sometimes used to describe this mechanism. There could also be some offsetting economic consequences from the exchange rate valuation effects of foreign currency assets. However, we expect the effects of exchange rate changes through foreign currency liabilities to predominate over those through foreign currency assets. Foreign currency assets are often held by "long-term" investors, such as pension funds, or foreign exchange reserves managers, from which valuation changes are likely to elicit smaller changes in spending. In addition, in much the same way as an interest rate cut can stimulate the economy by transferring income from savers to borrowers, an appreciation can stimulate the economy through the transfer of net wealth from foreign currency savers to borrowers. Whether an exchange rate appreciation is contractionary or expansionary rests on whether the trade or financial channel predominates. The strength of the trade channel depends on the nature of trade flows, while the intensity of the financial channel depends on the sensitivity of domestic balance sheets to the exchange rate and the amount of foreign borrowing. The intensity of both of these channels can differ across countries for a range of reasons. So an appreciation may be contractionary for some countries but expansionary for others. This article extends BIS a to consider empirically the relative strength of the trade and financial channels, taking into account differences between countries and providing some insight into the mechanisms at work by examining the response of GDP components. We find evidence that the financial channel partly offsets the trade channel for emerging market economies EMEs but that it is weaker for advanced economies. Investment is found to be particularly sensitive to the financial channel. We first review the relevant empirical literature on the trade and financial channels. We then describe our empirical approach to examining the two channels. This involves the use of the trade-weighted exchange rate to capture the trade channel and the debt-weighted exchange rate to capture the financial channel. The construction of the latter, which draws on BIS debt statistics, is outlined in a box. The trade channel The trade channel of exchange rates links changes in exchange rates to export and import volumes via the prices of traded goods. If export prices are fixed in domestic currency, then the full effect of an exchange rate depreciation will "pass through" to lower export prices as measured in the foreign currency. Foreign demand for exports typically increases as their foreign currency price falls, and so a depreciation will raise export volumes. Equivalently, a depreciation is typically passed through to higher domestic prices for imports, which will generally result in a lower

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volume of imports. Both import and export effects imply that an exchange rate depreciation increases net exports, while an appreciation reduces them. However, pass-through to export and import prices may be incomplete, meaning that the change in foreign currency export prices and domestic currency import prices may be smaller than the change in the exchange rate. A range of factors influences the extent of exchange rate pass-through into trade prices as well as the response of trade volumes to the prices of traded goods. The strength of the trade channel can then differ widely across countries. One important factor is the nature of trade. For example, if a country exports generic goods, such as commodities, for which there is a world price, there will likely be no pass-through of exchange rate changes to the export price, and domestic currency export prices will therefore fully reflect the exchange rate change. Conversely, for a specialised good, or one for which the exporting country is a major producer, the exporting country will generally have some influence over the world price, meaning there will be partial pass-through. Further, traded goods prices may not be invoiced in the currency of the importer or exporter, but in a specific "invoicing currency" such as the US dollar. In this case the exchange rate against this invoicing currency will be the one relevant for traded goods price and volume effects. If foreign currency export prices are unchanged with a depreciation, then the domestic currency price of exports will rise. The increased profits resulting from higher prices can stimulate investment through greater retained earnings, or consumption through higher payments to the owners of exporting firms. Through the same mechanism, an appreciation can depress economic activity. Service prices have been found to be more responsive to exchange rates in the short run Cole and Nightingale , while more specialised goods tend to have variable markups and so their prices are less sensitive to exchange rate movements Burstein and Gopinath Pass-through can depend not only on the type of export but also the characteristics of the exporting firm. Amiti et al show that, while pass-through is nearly complete for small non-importing firms, for large import-intensive exporters it is only half so. Berman et al find that highly productive firms vary their markup and so have less pass-through in response to exchange rate movements. Trade elasticities can also be influenced by country-level factors. Indeed, they find that export and import price elasticities are correlated across countries. The extent of pass-through can also vary over time, for structural and cyclical reasons. Pass-through can also decline because of growing trade integration Gust et al and in particular because of the increasing role of global value chains see Ahmed et al and Kharroubi on how this also influences trade balances. Moreover, pass-through can also vary depending on the nature of shocks hitting the economy, as shown by Forbes et al Overall, the strength of the trade channel for an economy will depend not only on the responsiveness of traded goods prices and volumes to the exchange rate but also on the share of exports and imports in economic activity the trade share. Hence it is not surprising that the strength of this channel is typically found to differ markedly across countries. Auboin and Ruta and Leigh et al provide more detailed surveys of the extensive literature on the relationship between the exchange rate and trade. The financial channel The financial channel of exchange rates, sometimes also referred to as the risk-taking channel, works in the opposite direction to the trade channel. The financial channel describes how exchange rate movements influence the supply and cost of foreign funding, and hence domestic economic activity. The simplest case is when there is an unhedged currency mismatch, for example when a non-financial corporate borrows in foreign currency to finance domestic currency assets such as real estate. If a borrower has local currency assets but foreign currency borrowing, then its net worth rises with an appreciation of the local currency. There can be both a price and quantity aspect to the financial channel. The improved creditworthiness of borrowers that comes with a local currency appreciation can lift the supply of foreign currency lending. Bruno and Shin b find empirical support for their model in which local currency appreciation is associated with higher leverage of the domestic banking sector through its interaction with global banks. In addition, if an appreciation results in an apparently lower risk profile for foreign currency borrowers, this may reduce their risk spreads and hence their borrowing costs. Hofmann et al forthcoming find that risk spreads decline as EME currencies appreciate against the dollar but not if they appreciate against other currencies. The financial channel can thus lead to a cycle through which appreciation against global

funding currencies increases the supply, and reduces the cost, of foreign lending. This will boost interest-sensitive domestic spending. Conversely, a contraction in financial conditions and economic activity will follow a local currency depreciation. These effects will generally be more potent in EMEs, where unhedged foreign currency exposures are more likely to be present, in part because of less-developed financial systems. However, advanced economies may be affected too. Rey finds that US monetary policy shocks are transmitted internationally even to countries with developed financial markets and flexible exchange rates. Importantly, the relevant exchange rate for the financial channel is the one against international funding currencies, predominantly the US dollar and increasingly the euro, but also the yen, Swiss franc and pound sterling. In contrast, the trade channel is sensitive to the trade-weighted exchange rate, ie the weighted exchange rate against countries with which the country trades and competes in global markets. We use a univariate autoregressive distributed lag ARDL model to compute the short- and long-run elasticity of GDP and its components with respect to the two exchange rate variables. In principle, both GDP and exchange rates could be driven by a common unmodelled factor, or the causality may run from GDP growth to exchange rates. For instance, financial booms can coincide with exchange rate appreciations. We take two steps to limit such concerns. First, we include control variables to account for domestic and foreign factors that could influence the relationship between exchange rates, and GDP and its components. Second, acknowledging the autocorrelation in the data given the quarterly frequency, we include lags of both the dependent and the independent variables. The lagged dependent variables are particularly useful in mitigating the consequences of model misspecification in quarterly data. The model is given by Equation 1: Box A

Debt-weighted exchange rate indices Bat-el Berger There are several possible ways of calculating debt-weighted exchange rate DWER indices, depending on what measure of debt is used to weight bilateral exchange rates. More concretely, the debt measure could vary along two main dimensions: The first possible debt measure is foreign currency-denominated external debt cell A in Table A. This is the narrowest of the four possible measures. It does not take into account the importance of external debt in total debt and the importance of domestic currency debt in external debt. Consequently, for countries whose foreign currency-denominated external debt is a modest share of total debt eg the United States , even large swings of the index would have a minor impact on domestic financial conditions. The second potential debt measure is total foreign currency-denominated debt cell B in Table A. This is a more complete measure than the one in cell A since it incorporates local debt denominated in foreign currencies. That said, it still suffers from the problem that total foreign currency debt could be a relatively small share of total debt for certain economies eg China. The third possible debt measure is external debt denominated in all currencies cell C in Table A. Nevertheless, it ignores any local debt, including local debt denominated in foreign currencies. Therefore, it could provide a misleading picture for countries in which a large portion of the domestic debt is denominated in foreign currencies eg the Czech Republic, Hungary and Poland. The final potential debt measure is total debt denominated in all currencies cell D in Table A. This is the most comprehensive of the four measures since it includes total debt and a weight is given to debt in domestic currencies. Nevertheless, this measure tends to be too broad for addressing a large number of questions. For example, the value of the index is likely to be very close to 1 for countries in which the share of domestic debt in domestic currency is large eg China. In theory, the "total debt" used for the construction of DWER indices should encompass the debt of only those entities that can actually choose their financing currency. In practice, however, this perimeter is not easily identifiable. We opt to construct our benchmark DWER indices using the weights based on foreign currency-denominated total debt ie cell B in Table A.

## Chapter 4 : Exchange rate volatility and productivity growth: The role of financial development

*We propose an econometric procedure for obtaining de facto exchange rate regime classifications which we apply to study the relationship between exchange rate regimes and economic growth.*

Trade and, relatedly, the volatility and flexibility of exchange rates have often been cited, for both advanced and emerging market economies. Has lack of exchange rate flexibility slowed down recoveries in the euro-area periphery? Has the fluctuation of the dollar impeded U. Are emerging market economies being hurt by exchange rate volatility? Theory proposes multiple ways in which exchange rate regimes can influence post-recession growth. If the exchange rate is flexible, the resulting depreciation makes exports more competitive and stimulates growth. Countries with pegged nominal exchange rate regimes cannot have quick real exchange rate adjustments because the nominal exchange rate does not move and prices are typically slow to change due to nominal rigidities. With such regimes, therefore, export growth may rise only gradually after recessions, leading to slower recoveries. Klein and Shambaugh find positive gains to bilateral trade between a pegged country and its base. Intuitively, they argue that a peg, by providing a more reliable outlook for the exchange rate, helps encourage trade relationships. If growth were strong in the base-currency country and trade linkages were sizable, pegged regimes could experience stronger recoveries through trade. Countries with pegged regimes also keep the value of their foreign-denominated debt stable, as often much of their foreign debt is denominated in the currency of the base country. Economies with flexible regimes could experience negative balance sheet effects: Past empirical work on the implications for growth of exchange rate choice has focused on structural growth or output volatility rather than specifically on the behavior of output following recessions e. Ghosh et al, , Husain et al, , and Levy-Yeyati and Sturzenegger, , and the results have been mixed. One study particular to recoveries is Tsangarides , which finds that countries with pegged regimes seem to recover more slowly than those with floating regimes, but the research examines only the post-GFC period in emerging market economies. We look at this issue for a wider range of countries over a longer time period capturing multiple recession periods and use somewhat different methodology. To examine the role of exchange rate regimes in fostering economic recovery, we use quarterly real GDP data for 52 countries 23 advanced economies AEs and 29 emerging market economies EMEs from around to table 1. Given the differences in recovery performance between these two types of economies, we do our analysis separately for each group Howard et al, Applying a standard recession dating technique, we identify over recessions. To best capture the economic impact of exchange rate regime choice, we use the de facto classifications--i. Reflecting this, we examine the euro-area countries separately in much of our analysis.

## Chapter 5 : Effective exchange rate indices

*We propose an econometric procedure for obtaining de facto exchange rate regime classifications which we apply to study the relationship between exchange rate regimes and economic growth. Our classification method models the de jure regimes as outcomes of a multinomial logit choice problem.*

Currency pair In the foreign exchange market, a currency pair is the quotation of the relative value of a currency unit against the unit of another currency. In other words, this is the price of a unit of Euro in US dollars. There is a market convention that determines which is the fixed currency and which is the variable currency. In most parts of the world, the order is: Cyprus and Malta, which were quoted as the base[ clarification needed ] to the USD and others, were recently removed from this list when they joined the Eurozone. In order to determine which is the fixed currency when neither currency is on the above list i. This reduces rounding issues and the need to use excessive numbers of decimal places. There are some exceptions to this rule: Using direct quotation, if the home currency is strengthening that is, appreciating , or becoming more valuable then the exchange rate number decreases. Conversely, if the foreign currency is strengthening and the home currency is depreciating , the exchange rate number increases. Market convention from the early s to was that most currency pairs were quoted to four decimal places for spot transactions and up to six decimal places for forward outright or swaps. The fourth decimal place is usually referred to as a " pip ". An exception to this was exchange rates with a value of less than 1. Although there is no fixed rule, exchange rates numerically greater than around 20 were usually quoted to three decimal places and exchange rates greater than 80 were quoted to two decimal places. Currencies over were usually quoted with no decimal places for example, the former Turkish Lira. In other words, quotes are given with five digits. Where rates are below 1, quotes frequently include five decimal places. A number of other banks have now followed this system. Exchange rate regime[ edit ] Main article: Exchange rate regime Each country determines the exchange rate regime that will apply to its currency. For example, the currency may be free-floating, pegged fixed , or a hybrid. If a currency is free-floating, its exchange rate is allowed to vary against that of other currencies and is determined by the market forces of supply and demand. Exchange rates for such currencies are likely to change almost constantly as quoted on financial markets , mainly by banks , around the world. A movable or adjustable peg system is a system of fixed exchange rates , but with a provision for the revaluation usually devaluation of a currency. China was not the only country to do this; from the end of World War II until , Western European countries all maintained fixed exchange rates with the US dollar based on the Bretton Woods system. Nixon in a speech on August 15, , in what is known as the Nixon Shock. Still, some governments strive to keep their currency within a narrow range. As a result, currencies become over-valued or under-valued, leading to excessive trade deficits or surpluses. Exchange rate classification[ edit ] 1. From the perspective of bank foreign exchange trading 1 buying rate: Also known as the purchase price, it is the price used by the foreign exchange bank to buy foreign currency from the customer. Also known as the foreign exchange selling price, it refers to the exchange rate used by the bank to sell foreign exchange to customers. It is the average of the bid price and the ask price. Commonly used in newspapers, magazines or economic analysis. According to the length of delivery after foreign exchange transactions 1 spot exchange rate: It refers to the exchange rate of spot foreign exchange transactions. That is, after the foreign exchange transaction is completed, the exchange rate in Delivery within two working days. The exchange rate that is generally listed on the foreign exchange market is generally referred to as the spot exchange rate unless it specifically indicates the forward exchange rate. It will be delivered in a certain period of time in the future, but beforehand, the buyer and the seller will enter into a contract to reach an agreement. When the delivery date is reached, both parties to the agreement will deliver the transaction at the exchange rate and amount of the reservation. Forward foreign exchange trading is an appointment-based transaction, which is due to the different time the foreign exchange purchaser needs for foreign exchange funds and the introduction of foreign

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exchange risk. According to the method of setting the exchange rate 1 basic rate: Usually choose a key convertible currency that is the most commonly used in international economic transactions and accounts for the largest proportion of foreign exchange reserves. Compare it with the currency of the country and set the exchange rate. This exchange rate is the basic exchange rate. The key currency generally refers to a world currency, which is widely used for pricing, settlement, reserve currency, freely convertible, and internationally accepted currency. After the basic exchange rate is worked out, the exchange rate of the local currency against other foreign currencies can be calculated through the basic exchange rate. The resulting exchange rate is the cross exchange rate. According to the payment method in foreign exchange transactions: Telegraphic exchange rate, Mail transfer rate, Demand draft rate 2. According to the level of foreign exchange controls 1 Official rate: Usually used by countries with strict foreign exchange controls. The market exchange rate refers to the real exchange rate for trading foreign exchange in the free market. It fluctuates with changes in foreign exchange supply and demand conditions. According to the international exchange rate regime 1 fixed exchange rate: The local currency is determined by the supply and demand relationship of the foreign exchange market, and it is free to rise and fall. Whether there including inflation 1 nominal exchange rate: The nominal exchange rate eliminating inflation Factors affecting the change of exchange rate[ edit ] 1. Balance of payments When a country has a large international balance of payments deficit or trade deficit, it means that its foreign exchange earnings are less than foreign exchange expenditures and its demand for foreign exchange exceeds its supply, so its foreign exchange rate rises, and its currency depreciates. Interest rate level Interest rates are the cost and profit of borrowing capital. When a country raises its interest rate or its domestic interest rate is higher than the foreign interest rate, it will cause capital inflow, thereby increasing the demand for domestic currency, allowing the currency to appreciate and the foreign exchange depreciate. Inflation factor The inflation rate of a country rises, the purchasing power of money declines, the paper currency depreciates internally, and then the foreign currency appreciates. If both countries have inflation, the currencies of countries with high inflation will depreciate against those with low inflation. The latter is a relative revaluation of the former. In general, the huge fiscal revenue and expenditure deficit caused by expansionary fiscal and monetary policies and inflation will devalue the domestic currency. The tightening fiscal and monetary policies will reduce fiscal expenditures, stabilize the currency, and increase the value of the domestic currency. Venture capital If speculators expect a certain currency to appreciate, they will buy a large amount of that currency, which will cause the exchange rate of that currency to rise. Conversely, if speculators expect a certain currency to depreciate, they will sell off a large amount of the currency, resulting in speculation. The currency exchange rate immediately fell. Speculation is an important factor in the short-term fluctuations in the exchange rate of the foreign exchange market. The foreign exchange supply and demand has caused the exchange rate to change. Fluctuations in exchange rates[ edit ] A market-based exchange rate will change whenever the values of either of the two component currencies change. A currency becomes more valuable whenever demand for it is greater than the available supply. It will become less valuable whenever demand is less than available supply this does not mean people no longer want money, it just means they prefer holding their wealth in some other form, possibly another currency. Increased demand for a currency can be due to either an increased transaction demand for money or an increased speculative demand for money. The more people that are unemployed , the less the public as a whole will spend on goods and services. Central banks typically have little difficulty adjusting the available money supply to accommodate changes in the demand for money due to business transactions. Speculative demand is much harder for central banks to accommodate, which they influence by adjusting interest rates. A speculator may buy a currency if the return that is the interest rate is high enough. It has been argued[ by whom? When that happens, the speculator can buy the currency back after it depreciates, close out their position, and thereby take a profit. Therefore, most carriers have a CAF charge to account for these fluctuations. There are various ways to measure RER. This is the exchange rate expressed as dollars per euro times the relative price of the two currencies in terms of their ability to purchase units of the market basket euros per goods unit divided by dollars per goods unit. If all

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goods were freely tradable, and foreign and domestic residents purchased identical baskets of goods, purchasing power parity PPP would hold for the exchange rate and GDP deflators price levels of the two countries, and the real exchange rate would always equal 1. The rate of change of the real exchange rate over time for the euro versus the dollar equals the rate of appreciation of the euro the positive or negative percentage rate of change of the dollars-per-euro exchange rate plus the inflation rate of the euro minus the inflation rate of the dollar. Real exchange rate equilibrium and misalignment[ edit ] The Real Exchange Rate RER represents the nominal exchange rate adjusted by the relative price of domestic and foreign goods and services, thus reflecting the competitiveness of a country with respect to the rest of the world. Nevertheless, the equilibrium RER is not a fixed value as it follows the trend of key economic fundamentals, [19] such as different monetary and fiscal policies or asymmetrical shocks between the home country and abroad. Starting from s, in order to overcome the limitations of this approach, many researchers tried to find some alternative equilibrium RER measures. Internal balance is reached when the level of output is in line with both full employment of all available factors of production, and a low and stable rate of inflation. Particularly, since the sustainable CA position is defined as an exogenous value, this approach has been broadly questioned over time. A nominal effective exchange rate NEER is weighted with the inverse of the asymptotic trade weights. Parallel exchange rate[ edit ] In many countries there is a distinction between the official exchange rate for permitted transactions and a parallel exchange rate that responds to excess demand for foreign currency at the official exchange rate. The degree by which the parallel exchange rate exceeds the official exchange rate is known as the parallel premium. If US interest rates increase while Japanese interest rates remain unchanged then the US dollar should depreciate against the Japanese yen by an amount that prevents arbitrage in reality the opposite, appreciation, quite frequently happens in the short-term, as explained below. The future exchange rate is reflected into the forward exchange rate stated today. In our example, the forward exchange rate of the dollar is said to be at a discount because it buys fewer Japanese yen in the forward rate than it does in the spot rate. The yen is said to be at a premium. UIRP showed no proof of working after the s.

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*The aim of this paper is to examine the theoretical and empirical arguments for the relationship between the exchange-rate regime and economic growth. As a nominal variable, the exchange rate (regime) might not affect the long-run economic growth.*

The scheme ranks exchange rate arrangements on the basis of their degree of flexibility and the existence of formal or informal commitments to exchange rate paths. It distinguishes among different forms of exchange rate regimes, in addition to arrangements with no separate legal tender, to help assess the implications of the choice of exchange rate arrangement for the degree of monetary policy independence. The following explains the categories.

**Exchange Rate Regimes**

**Exchange Arrangements with No Separate Legal Tender** The currency of another country circulates as the sole legal tender formal dollarization , or the member belongs to a monetary or currency union in which the same legal tender is shared by the members of the union.

**Currency Board Arrangements** A monetary regime based on an explicit legislative commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate, combined with restrictions on the issuing authority to ensure the fulfillment of its legal obligation. This implies that domestic currency will be issued only against foreign exchange and that it remains fully backed by foreign assets, eliminating traditional central bank functions, such as monetary control and lender-of-last-resort, and leaving little scope for discretionary monetary policy. Some flexibility may still be afforded, depending on how strict the banking rules of the currency board arrangement are.

**Other Conventional Fixed Peg Arrangements** The country formally or de facto pegs its currency at a fixed rate to another currency or a basket of currencies, where the basket is formed from the currencies of major trading or financial partners and weights reflect the geographical distribution of trade, services, or capital flows. The currency composites can also be standardized, as in the case of the SDR. There is no commitment to keep the parity irrevocably. The monetary authority stands ready to maintain the fixed parity through direct intervention i. Flexibility of monetary policy, though limited, is greater than in the case of exchange arrangements with no separate legal tender and currency boards because traditional central banking functions are still possible, and the monetary authority can adjust the level of the exchange rate, although relatively infrequently. There is a limited degree of monetary policy discretion, depending on the band width. Maintaining a crawling peg imposes constraints on monetary policy in a manner similar to a fixed peg system. The degree of exchange rate flexibility is a function of the band width. Bands are either symmetric around a crawling central parity or widen gradually with an asymmetric choice of the crawl of upper and lower bands in the latter case, there may be no preannounced central rate. The commitment to maintain the exchange rate within the band imposes constraints on monetary policy, with the degree of policy independence being a function of the band width.

**Managed Floating with No Predetermined Path for the Exchange Rate** The monetary authority attempts to influence the exchange rate without having a specific exchange rate path or target. Indicators for managing the rate are broadly judgmental e. Intervention may be direct or indirect.

**Independently Floating** The exchange rate is market-determined, with any official foreign exchange market intervention aimed at moderating the rate of change and preventing undue fluctuations in the exchange rate, rather than at establishing a level for it.

**Monetary Policy Framework** The exchange rate regimes are presented alongside monetary policy frameworks in order to present the role of the exchange rate in broad economic policy and help identify potential sources of inconsistency in the monetary-exchange rate policy mix. This type of regime covers exchange rate regimes with no separate legal tender; currency board arrangements; fixed pegs with and without bands; and crawling pegs with and without bands.

**Monetary Aggregate Anchor** The monetary authority uses its instruments to achieve a target growth rate for a monetary aggregate, such as reserve money, M1, or M2, and the targeted aggregate becomes the nominal anchor or intermediate target of monetary policy.

**Inflation Targeting Framework** This involves the public announcement of medium-term numerical targets for inflation with an institutional commitment by the monetary authority to

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achieve these targets. Additional key features include increased communication with the public and the markets about the plans and objectives of monetary policymakers and increased accountability of the central bank for attaining its inflation objectives. Monetary policy decisions are guided by the deviation of forecasts of future inflation from the announced target, with the inflation forecast acting implicitly or explicitly as the intermediate target of monetary policy. Fund-Supported or Other Monetary Program This involves implementation of monetary and exchange rate policies within the confines of a framework that establishes floors for international reserves and ceilings for net domestic assets of the central bank. Indicative targets for reserve money may be appended to this system. Other The country has no explicitly stated nominal anchor but rather monitors various indicators in conducting monetary policy, or there is no relevant information available for the country.

## Chapter 7 : Effective Exchange Rate Classifications and Growth - CORE

*The real effective exchange rate measures the value of a currency against a basket of other currencies; it takes into account changes in relative prices and shows what can actually be bought. Sterling effective exchange rate index. The effective exchange rate measures a currency against a basket of.*

## Chapter 8 : Does the financial channel of exchange rates offset the trade channel?

*To best capture the economic impact of exchange rate regime choice, we use the de facto classifications--i.e. how a country's exchange rate actually behaves, rather than de jure--what a country officially says its regime is. 4 For countries in the euro area, the classification of exchange rate regime is a bit tricky. The euro behaves as a fixed.*

## Chapter 9 : Exchange rate - Wikipedia

*growth per capita on countries, real exchange rate, controlling for time and country -ed effects, and instrumenting the real exchange rate with a measure of global capital flows interacted with a variable measuring countries' sensitivity to such flows: de jure -nancial.*