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FOREIGN ECONOMIC ACTIVITIES
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The following issues are covered: currency relations and currency systems, balances of international settlements, exchange rate, exchange rate regime, foreign exchange interventions. Intended for students of magistracy studying in the direction of preparation 38.04.02 “Management”.

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INTRODUCTION

The purpose of studying the discipline “Foreign economic activity” is familiarization with the main trends in the development of foreign economic activity as an integral economic system, the disclosure of the main forms of economic relationships, analysis of foreign economic activity. A distinctive feature of the course is that the main issues of foreign economic activity are presented from the point of view of Russia’s national interests and prospects.

Objectives of studying the discipline:
– study of the main system elements, the level and dynamics of their development;
– consideration of the main trends and problems;
– study of the structural features of foreign economic activity;
– familiarization with the basic theories of foreign economic activity.

The study guide is compiled in accordance with the course program and includes eight topics. The content of the course topics reflects modern and promising directions of development of foreign economic activity, contributes to the acquisition of the necessary research skills and solving problems related to management in modern economic conditions, explains the main processes and phenomena of foreign economic activity, helps to understand the main trends in foreign economic activity, to determine their nature.

To help students, an apparatus for organizing the assimilation of knowledge is offered: control questions and tasks on each topic.
1. CURRENCY RELATIONS AND CURRENCY SYSTEMS

The study of international monetary relations was long the domain of economists and a few lonely political scientists. It was routinely argued that, unlike international trade, debt, or foreign investment, exchange rates and related external monetary policies were too technical, and too remote from the concerns of either the mass public or special interests, to warrant direct attention from political economists (Gowa 1988). This was never really accurate, as demonstrated historically by the turbulent politics of the gold standard and more recently by the attention paid to currency policy in small, open economies such as those of Northern Europe and the developing world. But the tedious predictability of currency values under the Bretton Woods system lulled most scholars into inattention (exceptions include Cooper 1968, Kindleberger 1970, Strange 1971, Cohen 1977, Odell 1982, Gowa 1983).

The collapse of Bretton Woods increased the interest of political scientists in the issue, and in the 1980s, international monetary affairs took so prominent a place in domestic and international politics as to warrant widespread scholarly attention. The 50% real appreciation of the US dollar and the domestic and international firestorm of concern it prompted, dramatic currency collapses in many heavily indebted developing countries, and the controversial attempts to fix European exchange rates all drew researchers toward the topic.

Since 1990, international monetary relations have become extremely prominent in practice, and the study of their political economy has accordingly increased in importance. Exchange rate policies have been at the center of what are arguably the two most striking recent developments in the international economy: the creation of a single European currency and the waves of currency crises that swept through Asia, Latin America, and Russia between 1994 and 1999.

Although most research on the political economy of international monetary relations is relatively recent, it has already given rise to interesting and important theoretical approaches, analytical arguments, and empirical conclusions. We summarize this work without attempting to cover exhaustively a complex and rapidly growing literature. In this section, we outline the analytical problem, delineating the range of outcomes in need of explanation. The next section focuses on one set of things to be explained, the policy choices of national governments, surveying work on the domestic political economy of exchange rate
choice. The third section looks at the second set of things to be explained, the rise and evolution of regional and global exchange rate institutions.

Two interrelated sets of international monetary phenomena require explanation. The first is national: the policy of particular governments towards their exchange rates. The second is global: the character of the international monetary system. These two interact in important ways. National policy choices, especially of large countries, have a powerful impact on the nature of the international monetary system. The United Kingdom and the United States were essentially the creators of the classical gold standard and the Bretton Woods monetary order, respectively, and their decisions to withdraw from these systems effectively ended them. By the same token, the global monetary regime exercises a powerful influence on national policy choice. A small country, such as Belgium or Costa Rica, is much more likely to fix its exchange rate – to gold before 1914, to the dollar or some other currency since 1945 – when most of its neighbors have done so. The national and the international interact in complex ways, but for ease of analysis it is useful to look at separate dependent variables: the national policy choices of governments and the character of the international monetary system.

National Exchange Rate Policy

Each national government must decide whether to fix its currency – to the dollar, to another national currency, or to gold (in earlier periods) – or to allow it to float. If it chooses to let its currency float, it must decide whether it intends to let currency markets freely set the currency’s value or whether it intends to target a particular range of exchange rates. If the latter, the government needs to determine the desired level of the currency’s value – whether, generally speaking, it prefers the exchange rate to be “strong” (relatively appreciated) or “weak” (relatively depreciated). In specific instances, governments may be faced with more immediate choices, such as whether to defend or devalue a currency under attack. There are, roughly speaking, two kinds of national decisions to be made. One concerns the regime under which the currency is managed (fixed or floating, for example), and the other concerns the level of the currency (strong or weak).

These choices have significant economic and political implications, and there is no reigning economic argument as to the optimal national exchange rate policy. In this, international monetary policy differs from trade policy. There are powerful economic arguments for the welfare superiority of free trade, and free trade can usefully be considered
a baseline from which national policies deviate, with the "distance" from free trade a measure worth explaining. In currency policy, there is no clear economic-efficiency argument for or against any particular level of the real exchange rate. A strong (appreciated) currency is one that is valuable relative to others; this gives national residents greater purchasing power. However, a strong currency also subjects national producers of tradable products (goods and services that enter into international trade) to more foreign competition, for the strong currency makes foreign products relatively cheaper. Although politicians certainly care about these effects – weighing the positive effects of increased mass incomes versus the negative effects of increased foreign competition – there is no purely economic reason to opt for one or the other. There is a reigning economic approach to currency unions (and, somewhat by extension, to fixed exchange rates), drawn from the literature on optimal currency areas. But this literature is by no means conclusive, so even here there are few purely economic factors that could explain national government policy.

This means that national exchange rate policy must be made with an eye toward its political implications, since the tradeoffs governments must weigh are largely among values given different importance by different sociopolitical actors. Governments must evaluate the relative importance of the purchasing power of consumers, the competitiveness of producers of tradable products, and the stability of nominal macroeconomic variables. Below we survey the political considerations that affect policy, but first we describe the international level of analysis in international monetary affairs.

**International Monetary Systems**

There are effectively two ideal types of international monetary regime, with actual systems tending toward one or the other. One is a fixed-rate system, in which national currencies are tied to each other at a publicly announced (often legally established) parity. Some fixed-rate systems involve a common link to a commodity such as gold or silver; others use a peg to a national currency such as the US dollar. The other ideal-typical monetary regime is is a free-floating system, in which national currency values vary according to market conditions and national macroeconomic policies. There are many potential gradations between these extremes.

In the past 150 years, the world has experienced three broadly defined international monetary orders. For about 50 years before World War I, and again in substantially modified form in the 1920s, most of the
world’s major nations were on the classical gold standard, a quintessential fixed-rate system. Under the gold standard, national governments announced a fixed gold value for their currencies and committed themselves to exchange gold for currency at this rate. From the late 1940s until the early 1970s, the capitalist world was organized into the Bretton Woods monetary order, a modified fixed-rate system. Under Bretton Woods, national currencies were fixed to the US dollar and the US dollar was fixed to gold. However, national governments could and did change their exchange rates in unusual circumstances, so that currencies were not as firmly fixed as under the classical gold standard. From 1973 until the present, and briefly in the 1930s, the reigning order has been one in which the largest countries had more or less freely floating national currencies with no nominal anchor, whereas smaller countries tended either to fix against one of the major currencies or to allow their currencies to float with varying degrees of government management.

Monetary regimes can be regional as well as global. Within the international free-for-all that has prevailed since 1973, a number of regional fixed-rate systems have emerged or been contemplated. Some have involved simply fixing the national currencies of relatively small countries to the currency of a larger nation; for instance, the CFA (African Financial Community) franc zone ties the currencies of 12 African countries to each other and to the French franc (and now to the euro). Several countries in Latin America and the Caribbean have similarly tied their currencies to the US dollar, and others are considering this link. Another type of regional fixed-rate system involves the linking of a number of regional currencies to one another, often as a step toward adoption of a common currency. This has been the case with European monetary integration, which began with a limited regional agreement, evolved into something like a Deutsche mark link, and eventually became a monetary union with a single currency and a common European central bank. Countries in the Eastern Caribbean and southern Africa have also developed monetary unions.

Our dependent variables, then, are (a) the national exchange rate policies of particular national governments, especially their choice of the level and regime of their currencies; and (b) the international monetary regime, especially the degree to which currencies are fixed against one another. To be sure, these two dependent variables are jointly determined. National policy choices depend on the character of the international monetary system, and the evolution of global monetary relations is powerfully affected by the decisions of the major trading and investing
nations. By the same token, international monetary relations interact with other economic policies. Currency misalignments have often led to protectionist pressures and even trade wars, just as the evolution of trade relations affects exchange rate policy choices. Policies toward international financial and investment flows are similarly affected by, and affect, exchange rate movements. These complex interactive effects are important, but we do not know how to think about them in an integrated and systematic way. This essay focuses on the political economy of international monetary policy in and of itself, emphasizing potential answers to our two more narrowly defined explanatory questions.

Cognate literatures on the political economy of other important international economic policies are useful to the analysis of international monetary policy. Analyses of international trade and investment begin with a prior notion of the distributinal interests at stake – factoral, sectoral, and firm-specific – derived either from theory or from empirical investigation. They then explore how these interests are aggregated and mediated by such sociopolitical institutions as labor unions and business associations, political parties, electoral systems, legislatures, and bureaucracies. Finally, they explore the interactions between these nationally derived policies and those of other countries, especially in contexts in which interstate strategic interaction is likely to be important, such as where national government policies depend on the responses of other governments. The emerging structure of analysis and explanation of international monetary and financial politics follows this pattern. In the next section, we summarize the domestic level of analysis, especially how interests and institutions interact in the formation of national policy.

National policy makers make decisions about the exchange rate regime and the desired level of the currency. The regime decision is whether to allow the currency to float freely or to fix it against some other currency. Pure floats and irrevocably fixed regimes are, of course, only two possible options. There are at least nine existing regimes on a continuum that runs from a full float to a currency union—an extreme kind of fixed-rate system (Frankel 1999). For all regimes between the two extremes of this continuum, policy makers also confront choices related to the level of the exchange rate. Level decisions involve policies that affect the price at which the national currency is valued in foreign currencies. The exchange rate may itself be a target for policy, with a definite rate being set or a clearly observable formula applied. Alternatively, the exchange rate may be actively managed in conjunction with other components of monetary policy. Some governments announce
a band within the currency will be allowed to move, or they act (without public announcement) to restrict exchange rate movements to such a target band. Whatever the mechanism, level decisions fall along a second continuum that runs from a more depreciated to a more appreciated currency. Although regime and level decisions are interconnected, we treat them separately for heuristic purposes. We attempt to delineate the domestic political economy factors that influence governments’ choices along the two continuums.

Like other areas of economic policy, exchange rate decisions involve tradeoffs between desired goals. An established economics literature examines the costs and benefits of alternative currency policies from the perspective of a benevolent social planner, which is a useful starting point for gauging the attractiveness of policies in terms of national welfare. However, the more recent political economy scholarship incorporates the role of interest-group and partisan pressures, political institutions, and the electoral incentives of politicians. One major theme is that currency policy has domestic distributional implications that shape the sociopolitical environment in which policy makers assess costs and benefits. A second theme is that domestic electoral, legislative, and bureaucratic institutions influence the incentives of politicians as they confront currency policy tradeoffs. We develop these themes below, emphasizing that the economic tradeoffs are politically and institutionally conditioned.

To Fix or to Float

Our discussion of regime choice focuses on the extreme regimes – hard pegs and pure floats–because the analysis of intermediate cases flows from that of the extremes. The tradeoffs we describe apply to the intermediate choices – target zones, crawling pegs and bands, etc – albeit never as starkly as with the extremes (Frankel 1999). Economic treatments of regime choice come from two perspectives: (a) open economy macroeconomic approaches, including consideration of optimal currency area criteria; and (b) rational-expectations treatments of the credibility problem in monetary policy.

From the open economy perspective, the principal advantage of a fixed-rate regime is to lower the exchange rate risk and transaction costs that can impede international trade and investment (Mundell 1961, McKinnon 1962, Kenen 1969). Volatile exchange rates create uncertainty about international transactions, adding a risk premium to the costs of goods and assets traded across borders. Although it is possible to hedge against this risk in derivatives markets, hedging invariably involves costs,
which increase with the duration of the transaction. And recent experience indicates that there is a great deal of unexplained volatility in currency markets, which makes hedging particularly difficult for small countries’ currencies. By opting to stabilize the currency, a government can reduce or eliminate exchange rate risk and so encourage greater trade and investment – a desirable objective. Taking the next step to a currency union does away with the remaining transactions costs, providing an even stronger impetus toward economic integration.

Pegging, however, has costs. To gain the benefits of greater economic integration by fixing the exchange rate, governments must sacrifice their capacity to run an independent monetary policy. The “impossible trinity” principle explains that where capital is internationally mobile, a fixed rate and monetary independence are not simultaneously attainable (Mundell 1962, 1963). The principle says that a country must give up one of three goals: exchange rate stability, monetary independence, or financial market integration. When capital is mobile internationally, domestic interest rates cannot long differ from world interest rates, as capital flows induced by arbitrage opportunities quickly eliminate the differential. There is strong evidence in both developed economies (Marston 1995) and the developing world (Edwards 1999) that financial integration has progressed so far that capital mobility can be taken more or less as a given, which reduces the choice to sacrificing exchange rate stability versus giving up monetary independence. A fixed exchange rate with international capital mobility renders monetary policy ineffective, meaning that there is no leeway to use monetary policy for purposes of demand management or balance-of-payments adjustment. This poses a tradeoff between two competing values: stability and flexibility. Achieving monetary stability can be a substantial benefit for countries that have endured high and highly variable inflation and other domestic monetary disturbances. But since achieving this stability means forgoing monetary flexibility, this can be a substantial cost for countries that face severe external shocks to which monetary policy might be the appropriate response.

Whereas the traditional case for stable exchange rates hinges on the benefits of integration, recent analyses tend to place more emphasis on credibility issues and the role of fixed regimes in stabilizing inflation expectations. With roots in the rational expectations literature, this work builds on the time inconsistency problem described by Kydland & Prescott (1977), Barro & Gordon (1983). The problem arises when monetary policy is set with discretion and wages and prices are not fully flexible. Under
these conditions, a policy maker may try to fool private agents by inflicting an inflationary surprise, in the hope of engineering a temporary boost in output. However, forward-looking private actors anticipate this incentive and take it into account when forming their ex ante inflationary expectations. These expectations thus introduce an inflationary bias into wage bargaining and price setting. Consequently, when the policy maker adopts surprise inflation, the equilibrium outcome is higher inflation but not higher output. The key to solving this time inconsistency problem is credibility. If the private sector believes that the preannounced policy is credible, then expected inflation is kept in check at no cost to output.

Pegging the exchange rate provides an automatic rule for the conduct of monetary policy that avoids the time inconsistency problem and enhances the credibility of the government’s commitment to low inflation (Giavazzi & Pagano 1988, Canavan & Tommasi 1997). In a fixed regime, monetary policy must be subordinated to the requirements of maintaining the peg, effectively eliminating the discretion of the authorities. This privileges such domestic objectives as price stability over such external objectives as payments balance and competitiveness. Historically, a national commitment to a gold standard was the most important such external anchor. More recently, many countries have pegged to the currency of a large, low-inflation country (Mishkin 1999).

Although pegging is not the only way to commit policy to low inflation – central bank independence with price level or inflation targets may be an alternative – its transparency makes it a common commitment technology in contexts where the alternatives cannot easily be monitored by the public (Herrendorf 1999, Canavan & Tommasi 1997). When a government commits to a peg, it makes an easily verifiable promise. Either the government follows macroeconomic policies consistent with the peg, or it does not, in which case the peg collapses. There is in fact no technical reason why a peg cannot be maintained, even in the face of a large speculative attack (Obstfeld & Rogoff 1995). Therefore, devaluation is a public signal that the government has not lived up to its promise. The transparency of a peg enhances the credibility of the government’s commitment to low inflation but comes at price, measured in terms of lost monetary policy flexibility. The tradeoff here is between credibility and flexibility.

Do countries that choose pegs experience increases in trade and credibility. Time-series studies of the relationship between exchange rate volatility and trade (or investment) typically find small, weak negative effects (Frankel 1995). However, much stronger effects are evident
in cross-sectional evaluations. Countries that share a common currency (or have a long-term peg) trade more than three times as much as comparable countries that have separate currencies (Rose 2000). As for credibility, pegs tend to be favored commitment devices in countries seeking a quick resolution to chronic inflation (Vegh 1992). Systematic evidence from 136 countries over a 30-year period shows that pegging is indeed associated with lower inflation, but at the cost of more variable output than in flexible exchange rate regimes (Ghosh et al 1997).

Theory and evidence thus suggest that fixing the exchange rate to the currency of a low-inflation country (a) promotes international trade and investment and (b) disciplines monetary policy by providing an observable nominal anchor for the value of domestic money. The advantages of a floating exchange rate, on the other hand, reduce to the single, albeit crucial, property that it allows a government to have its own independent monetary policy. Under a full float, demand and supply for domestic currency against foreign currency are balanced in the market. There is no obligation or necessity for the central bank to intervene. Therefore, domestic monetary aggregates need not be affected by external flows, and a monetary policy can be pursued without regard to monetary policy in other countries. This independence is valuable because it provides flexibility to accommodate foreign and domestic shocks, including changes in the external terms of trade and interest rates. More generally, floating allows monetary policy to be set autonomously, as deemed appropriate in the domestic context (e.g. for stabilization purposes), and the exchange rate becomes a residual, following whatever path is consistent with the stabilization policy.

A related advantage of floating is that it allows the exchange rate to be used as a policy tool. This flexibility is valuable when real appreciation, caused by inertial inflation or rapid capital inflows, harms international competitiveness and threatens to generate a balance-of-payments crisis – a common syndrome in developing and transition economies that use a fixed exchange rate as a nominal anchor for credibility purposes (Edwards & Savastano 1999). When residual inflation generates an inflation differential between the pegging country and the anchor, it induces a real appreciation that, in the absence of compensating productivity gains, leads to balance-of-payments problems. A more flexible regime allows policy makers to adjust the nominal exchange rate to ensure the competitiveness of the tradable goods sector. However, the more flexible the regime, the smaller the credibility gains. The tradeoff between credibility and competitiveness is particularly relevant in
countries where inflation has been a persistent problem (Frieden et al 2001).

Which regime is best for a particular country is partly a matter of the economic characteristics of the country. The literature on optimal currency areas points to several considerations, with openness, economic size, sensitivity to shocks, and labor mobility between regions heading the list. Broadly speaking, when a region is characterized by easy movement of labor, or is highly integrated with its neighbors such that they share common disturbances, the gains of fixed exchange rates are likely to outweigh the costs of giving up monetary independence (Frankel 1995). Countries that are particularly sensitive to external disturbances (e.g. volatility in the terms of trade) are generally better off floating, whereas countries concerned about domestic monetary shocks gain from pegging. Furthermore, when the shocks affecting a country and it neighbors are highly correlated, there is less need of monetary independence because a single policy response is appropriate for the whole region. Beyond this, there is little consensus on the welfare criteria for exchange rate regime choice (Frankel 1999). Given the diversity of economic conditions relevant to selecting the optimal regime, it is not surprising that empirical findings are typically weak or contradictory (Tavlas 1994, Edison & Melvin 1990).

A more fundamental weakness of the both the credibility and open economy approaches is their implicit assumption that policy makers select currency regimes to maximize aggregate social welfare. There is little reason to believe that currency policy is made any less politically than other economic policies. In the next section, we depart from the benevolent social planner assumption and survey work that endogenizes the political incentives and constraints that shape regime decisions.

**Interest Groups and Regime Choice**

What is optimal for a country as a whole may not be optimal for particular groups within a country. A policy of free trade, for example, creates both winners and losers even though it is widely regarded as welfare-enhancing for the nation. These distributional effects form the basis of “endogenous tariff theory”, which accounts for deviations from free trade by delineating the groups that favor and oppose protection and the conditions under which they are most influential (Milner 1999). Currency regime choice, like the choice between free trade and protection, has domestic distributional consequences.

We begin by examining the strengths and weaknesses of pressure group or “demand-side” approaches to regime choice, which take the
distributional consequences of exchange rate regime choice as part of the explanation of its causes. We then introduce “supply-side” considerations, such as the character of domestic political and monetary institutions and the incentives of self-seeking politicians that inhabit them. Although aspects of the link between interests, politics, and policies remain underdeveloped, this literature contains the building blocks of the political economy of regime choice.

Regime choice involves tradeoffs between goals, as discussed above. Arguments that stress the demand for regimes maintain that societal groups have different preferences in the stability-vs-flexibility tradeoff. Recall that one important advantage of fixed rates is that international trade and investment can be conducted with minimal risk of capital losses due to currency fluctuations. The tradeoff is that fixed rates require the subordination of domestic monetary policy to currency and balance-of-payments considerations. A preliminary framework identifies how social groups align on the stability-vs-flexibility tradeoff (Frieden 1991, Hefeker 1997). In its simplest manifestation, groups are arranged along a continuum that measures the extent to which they are involved in international or domestic economic activity. Groups heavily involved in foreign trade and investment (i.e. producers of exportables, foreign direct and portfolio investors, and international merchants) should favor exchange rate stability, since currency volatility is an everyday concern that makes their business riskier and more costly. By the same token, these actors are relatively insensitive to the loss of monetary autonomy, since they typically conduct business in several countries and can therefore respond to unfavorable domestic macroeconomic conditions by shifting business or assets abroad.

By contrast, groups whose economic activity is confined to the domestic economy benefit from a floating regime. The nontradables sector (e.g. services, construction, transport) and import-competing producers of tradable goods belong in this camp. Producers of nontradables are not required to deal in foreign exchange, since their activities are, by definition, domestic. Thus, they are free of the risks and costs of currency volatility. The nontradables sector is, however, highly sensitive to domestic macroeconomic conditions and therefore favors the national autonomy made possible by floating. The same logic holds for producers of import-competing traded goods, with the added proviso that currency volatility may reduce competition from imports by adding to the risks and costs of importing.
The strength of the pressure group approach is that it yields clear predictions on the regime preferences of social groups in a manner similar to endogenous tariff theory. It also provides the basis for refining predictions. For example, the degree to which an export industry is sensitive to currency volatility will depend on its ability to “pass through” the costs to consumers in the form of price changes. Typically, industries in which product differentiation and reputation are important have less pass-through than producers of standardized goods, in which competition is based primarily on price (Goldberg & Knetter 1997). This implies that producers of internationally traded specialized products will be more concerned to reduce currency volatility than producers of standardized manufactured goods or commodities, and thus more likely to favor fixed exchange rates.

Pressure group arguments, however, are very difficult to evaluate. One problem is that, unlike trade policy, exchange rate regime decisions are rarely subject to votes in legislatures and hardly ever figure prominently in nationwide electoral outcomes and campaigns. The most systematic work on pressure groups and regime choice looks back over a century to the gold standard controversy for suitable data. In the 1890s, the US Congress voted repeatedly on the choice between the gold and silver standards (Frieden 1997). Similarly, the 1896 US presidential election was a rare nationwide election in which the central issue was the exchange rate regime; William Jennings Byran ran on a platform of monetizing silver and floating the dollar against gold standard currencies (Eichengreen 1995). European monetary integration in the nineteenth century provides a few additional cases (Hefeker 1995). These analyses, controlling for other factors, find that pressure group influences are significantly related to vote outcomes.

The number of cases available for empirical analysis may be increasing, as exchange rates have again gained domestic political prominence in recent years. The renewed salience may be due to the revival of international capital mobility, since capital mobility heightens the “impossible trinity” problem (Frieden 1996). In Europe, the post-Maastricht period was characterized by increasing turmoil and polarization on currency union. In developing countries, regime choice is currently a source of heated policy and electoral debate, and countries are experimenting with a variety of regimes (Edwards & Savastano 1999). The considerable variation of currency regimes in Latin America can be exploited to investigate the influence of interest group pressures. In this context, the credibility-vs-competitiveness tradeoff is especially important.
because of problems controlling inflation in the region. Consistent with the interest group perspective, economies with larger manufacturing sectors are more prone to adopt either floating regimes or backward-looking crawling pegs, both of which tend to deliver more competitive exchange rates (Frieden et al 2001). The influence of the manufacturing sector on the exchange regime is also found to be more important when trade is relatively open, because liberalized trade subjects manufacturers to greater foreign competition. These findings support the argument that the degree to which policy makers opt to sacrifice credibility to competitiveness is a function of the political influence of tradables producers.

The cross-sectional approach appears promising, even among developed countries, where the tradeoff between stability and flexibility is likely to dominate (Henning 1994, Frieden 2000). However, measuring group preferences and political influence is never easy, and data limitations leave analysts with crude proxies (e.g. a sector’s share of gross domestic product as a measure of its influence). An alternative strategy is to take the distributional arguments to the individual level of analysis and make use of available public opinion data on regime preferences and voting behavior (Scheve 1999). Scheve finds that asset ownership and high skill endowments are positively related to individuals’ expressed level of support for European monetary integration and to their voting behavior in nationwide elections. This connects individual preferences on monetary integration to voting, thus providing a direct test of the distributional implications of the open economy approach.

Despite these advances, it is unlikely that the interest group approach will spawn a literature as deep and rich as analogous work on trade policy. Pressure group activity on exchange rates is more limited than in trade affairs, owing to the macroeconomic nature of exchange rates and associated collective action constraints. Exchange rates have broad distributional effects, which reduce the incentives to lobby. For example, stable exchange rates benefit all industries in the export sector; in contrast, trade protection can be narrowly targeted to create rents for specific industries (Gowa 1988). Exchange rate policy is less excludable than trade policy, implying more free riding (Olson 1971). But just as work on trade has endogenized the free rider problem, so can analysis of currency policy. For example, highly concentrated industries should be more effective lobbyists for exchange rate policies, just as they are in trade policy (Trefler 1993). Although exchange rates may not evince as much lobbying as trade policy, lobbying is possible, even predictable across industries and
countries. More attention to collective action considerations would help us develop the links between group preferences, lobbying, and government regime decisions.

Class-Based (Partisan) Approaches to Regime Choice

Inasmuch as exchange rates have broad distribu tional effects, it makes sense to analyze the politics of regime choice at a broad level of political aggregation. Class-based partisan approaches typify this strategy. Where political parties aggregate the monetary preferences of social classes, centrist and rightist parties are presumed to be more inflation averse than leftist parties (Hibbs 1977). Center-right parties are thus likely to support fixed regimes, since their business constituencies benefit from the credible commitment to low inflation that fixing brings (Simmons 1994, Oatley 1997). By the same token, center-right parties are expected to be enthusiastic about stable exchange rates because of the expansion of trade and investment made possible by fixing. Left-wing parties, by contrast, favor flexible regimes, since labor bears the brunt of adjusting the domestic economy to external conditions (Simmons 1994).

Tests of the partisan arguments have produced mixed and often perverse results. For example, countries with more left-wing representation in government had a higher probability of staying on the gold standard during the interwar period than those with less (Simmons 1994, Eichengreen 1992). The reason may be that leftist governments had more need for the credibility that a commitment to gold could bring. However, left-wing governments devalued more frequently, conditioned on a downturn in the business cycle (Simmons 1994). This effect is also evident in contemporary Europe; leftist parties supported stable exchange rates in the mid-1980s (Garrett 1995, Oatley 1997). More generally, the partisan composition of government had small, weak, and occasionally perverse effects on the stability of European currencies between 1972 and 1994 (Frieden 2000). Another study of OECD countries in the post – Bretton Woods period found no relationship between partisanship and regime choice (Bernhard & Leblang 1999).

Partisan influences on regime choice are thus not straightforward. Indeed, the literature contains a number of factors that condition parties’ regime preferences and their political influence. Several of the most important mitigating factors include the degree of capital mobility (Goodman & Pauly 1993); linkage to other issue areas, such as trade, foreign, and agricultural policy (Giavazzi & Giovannini 1989, Frieden 2001); policy makers’ beliefs and the role of ideas (Odell 1982,
Collins & Giavazzi 1993, McNamara 1998); the centralization of wage bargaining institutions (Hall & Franzese 1998); and the independence of the central bank (Simmons 1994, Oatley 1997). Given the wide range of mitigating factors, it is not surprising that the ideology and influence of political parties vary tremendously among countries. Although this variation makes it difficult to construct generalizations, some of it may be due to analogous variation in electoral and legislative institutions.

**Political Institutions and Regime Choice**

Various combinations of electoral and legislative institutions can affect the electoral incentives of politicians in governing parties to adopt alternative exchange rate regimes (Bernhard & Leblang 1999). In countries where the stakes in elections are high, politicians might prefer floating exchange rates, so as to preserve the use of monetary policy as a tool for building support before elections (Clark & Hallerberg 2000). This is expected in majoritarian (single-member plurality) electoral systems, where a small swing in votes can lead to a large change in the distribution of legislative seats and to the ouster of the governing party. Electoral stakes are also a function of legislative institutions. In systems with weak, noninclusive committees, the costs of being in the minority are larger than in systems with strong, inclusive committees, since the opposition has little influence over policy. High electoral stakes imply that politicians in “majoritarian – low opposition influence” systems will want a flexible regime to preserve monetary independence, so as to use monetary policy to engineer favorable (if temporary) macroeconomic conditions before elections. In contrast, where elections are not as decisive – as in systems with proportional representation and strong, inclusive committees – fixed exchange rates impose lower electoral costs on politicians, implying that fixed regimes are more likely to be chosen.

A related argument concerns the timing of elections, which in some systems is determined endogenously by the government and in others is predetermined. When election timing is predetermined, governing parties are loath to surrender monetary policy flexibility by pegging, since monetary policy can be a valuable tool for winning elections. In contrast, when election timing is endogenous, there is less need to maintain monetary flexibility for electoral purposes; hence pegging is more likely (Bernhard & Leblang 1999). These arguments and the supporting evidence suggest that the structure of democratic institutions shapes the regime preferences of politicians and governing parties, so much so that it dominates the influence of partisanship on regime choice. This approach,
however, seems to be restricted to developed countries, where democratic structures are well established and stable, and where partisanship typically has a class basis. In developing countries, it may be the extent of democracy rather than its specific form that matters.

Political regime type (democratic to authoritarian) is in fact highly correlated with exchange rate regime choice in developing countries (Leblang 1999, Broz 2000). Nondemocratic systems are significantly more likely to adopt a fixed regime for credibility purposes than are democratic countries. Why authoritarian governments prefer pegs as a means to lower inflation is a matter of debate. Autocratic governments may peg because they are more insulated from domestic audiences and thus bear lower political costs of adjusting the economy to the peg (Simmons 1994, Leblang 1999). That is, lower political costs ex post increase the likelihood that autocracies will choose a peg ex ante. A weakness of the argument is that pegging is an inefficient means of generating credibility, given the availability of alternatives, such as central bank independence (CBI), that do not require a loss of exchange rate policy flexibility and that appear effective at reducing inflation (see Alesina & Summers 1993, Debelle & Fischer 1994, as compared to Ghosh et al 1997, on the relative inefficiency of currency pegs). An authoritarian regime that is insulated enough to maintain a peg would surely be capable of adopting an independent central bank, which would seem likely to improve inflation performance at a lower cost.

A competing argument is that the transparency of a pegged regime makes it a preferred commitment technology in authoritarian systems (Broz 2000). When political decision making is not transparent, as in autocracies, governments must look to a commitment technology that is more transparent and constrained (pegged exchange rates) than the government itself. For autocratic governments, a highly visible commitment substitutes for the lack of openness in the political system to engender low inflation expectations. In the case of legal CBI – an opaque commitment – democratic institutions provide an alternate source of transparency. For democracies, an opaque commitment such as CBI is rendered transparent indirectly through active monitoring by the media, inflation hawks in society, and the political opposition – audiences with stakes in exposing the government’s broken promises (Wittman 1989, Fearon 1994). Autocracies are thus more likely to adopt pegs than are democracies. In addition, the effectiveness of CBI in limiting inflation is conditioned on the level of political system transparency (Broz 2000). This suggests that the transparency of the monetary commitment and
the transparency of the political system are substitutes. It also challenges the view that fixed regimes and CBI are complementary commitment mechanisms (Simmons 1994, Maxfield 1997).

Although there is no consensus on the role of politics in exchange rate regime choices, it is recognized that considerations of aggregate social welfare provide a partial explanation at best. Regime decisions involve tradeoffs with domestic distributional and electoral implications; thus, selecting an exchange rate regime is as much a political decision as an economic one.

To Appreciate or Depreciate

If a nation’s regime lies between a pure float and an irrevocable peg on the regime continuum, its policy makers face choices about the desired level of the exchange rate. Completely free floats are in fact rare, for most governments act to reduce currency volatility even when the exchange rate is not publicly fixed. By the same token, countries that opt for a pegged regime always have the choice of abandoning the peg (Calvo & Reinhart 2000). Thus, under most regimes, a government must decide whether it prefers a relatively appreciated or a relatively depreciated currency. A full analysis of the costs and benefits involved in choosing the level of the exchange rate depends on the model of exchange rate determination to which one subscribes (portfolio balance, overshooting, new classical, speculative bubble, etc). For simplicity, we consider the tradeoff between competitiveness and purchasing power as especially crucial to the calculations of national policy makers.

The value of the real exchange rate affects the demand for domestic traded goods in both local and foreign markets. In the case of a real appreciation, domestic goods become more expensive relative to foreign goods; exports fall and imports rise as a result of the change in competitiveness. Real depreciation has the opposite effects, improving competitiveness. Real exchange rate changes sometimes stem from deliberate policy actions (see above). These policies are known as expenditure-switching policies because they alter the allocation of spending between domestic and foreign goods (equivalently, between traded and nontraded goods). Although a weaker currency increases the competitiveness of the international sector, it also raises the prices of foreign goods and services to domestic consumers, thereby eroding national purchasing power. If a nation imports many vital items, such as oil, food, or capital goods, depreciation can reduce living standards and retard economic growth, as well as cause inflation.
Beyond considerations based on the tradeoff between competitiveness and purchasing power, there is little agreement on what the appropriate level of the exchange rate should be. A real depreciation, for example, can encourage exports and a switch from imports to domestic goods, thereby boosting aggregate output. However, depreciation can also be contractionary, owing to its negative impact on real money balances that follows from a higher price level. Suffice it to say that changes in real exchange rates unleash a series of changes in economic relations, some positive and some negative, and the net effect on overall national welfare is very hard to calculate.

**Interest Groups and the Level of the Exchange Rate**

Despite this ambiguity, it is clear that the level of the exchange rate always has distributive consequences domestically, implying a role for interest group politics. Exporting and import-competing industries lose and domestically oriented (nontradables) industries gain from currency appreciation (Frieden 1991). Domestic consumers also gain as the domestic currency price of imported goods falls, lowering the cost of living. Currency depreciations have the opposite effects, helping exporting and import-competing industries at the expense of domestic consumers and producers of nontraded goods and services.

Like regime decisions, the currency preferences and political capabilities of groups are conditioned by many factors. For example, the degree to which tradables producers are directly affected by changes in the exchange rate conditions their sensitivity to currency movements. If import-competing firms faced by an appreciation of the home currency are able to keep their prices high – typically because foreign producers do not in fact pass the expected price decline through to local consumers – they will be less concerned by such an appreciation (this is typically the case in markets for specialized, highly differentiated products, such as automobiles).

Generally speaking, tradables industries with high pass-through are more sensitive to the relative price effects of currency movements than those with low pass-through, since their prices respond more directly to changes in exchange rates. By extension, the level of the exchange rate is likely to be more politicized in developing countries than in developed countries, since the former tend to produce standardized goods and primary commodities, for which pass-through is high. The extent to which an industry relies on imported intermediate inputs will also determine whether it is harmed or helped by appreciation. An industry with heavy dependence
on imported inputs relative to export revenue may actually see its profitability improve with appreciation (Campa & Goldberg 1997).

Within this complex range of possibilities, there are regularities that can be identified. These are related to points made above about regime preferences. For example, the argument that producers of simple tradables are relatively insensitive to currency volatility complements the argument that they are very sensitive to the level of the exchange rate. Such producers (of commodities and simple manufactures) will prefer a flexible regime and a tendency toward a depreciated currency. On the other hand, the argument that producers of complex and specialized tradables are very sensitive to currency volatility complements the argument that they are relatively insensitive to the level of the exchange rate. These producers will prefer a fixed regime. Capturing an industry’s (or an entire nation’s) sensitivity to exchange rate changes involves measuring the extent to which it sells products to foreign markets, uses foreign-made inputs, and, more indirectly, competes with foreign manufacturers on the basis of price (Frieden et al 2001).

In most instances, interest group activity on the level of the exchange rate is episodic and asymmetric. By episodic, we mean that it can take extraordinary conditions to move group members to organize on the issue. The 50% real appreciation of the dollar in the early and middle 1980s is a case where traded goods industries lobbied hard for policies to depreciate the dollar (Destler & Henning 1989, Frankel 1994). The rarity of such cases is partially understandable in collective action terms, as lobbying for depreciation is a public good for the entire traded goods sector. By asymmetric, we mean that lobbying from the “winners” of real appreciation (nontradables, consumers) does not usually arise to counteract pressure from the “losers.” That is, the groups that enjoy income gains from appreciation do not seem to mobilize politically. Consumers, of course, face high costs of collective action, and the same constraint may apply to the nontradables sector (Henning 1994). But using the rule of thumb that advanced economies are divided roughly equally between tradables and nontradables, the barriers to collective action should be symmetric.

Why we do not observe symmetric lobbying (or non-lobbying) on the exchange rate is a puzzle. The reason might be that tradables producers have the advantage of prior organization, having paid the startup costs to influence trade policy. A related point is that traded goods industries have the option of lobbying for industry-specific trade policies when the currency appreciates. Note that currency policy and trade policy are close
substitutes in terms of the compensation they provide: A 10% real depreciation is equivalent to a 10% import tax plus a 10% export subsidy (McKinnon & Fung 1993). Hence, the tradables sector can organize on an industry-by-industry basis to seek trade barriers or export subsidies, thus mitigating the free rider problem (Stallings 1993). In practice, policy makers do seem to address currency misalignments when demands for protection intensify (Destler & Henning 1989). For the nontradables sector, trade policies are not available, rendering lobbying for currency policies a sector-wide public good. An implication is that the bias in favor of tradables should diminish when free trade or international agreements restrict the ability of governments to use trade policy as a compensatory instrument. Take away trade policy and neither sector organizes. However, liberalizing trade might motivate previously organized traded goods industries to lobby on the exchange rate directly (Frieden et al 2001).

Political Institutions and the Level of the Exchange Rate

Direct interest group activity on the level of the exchange rate is muted, for the distributional effects are very broad based. Indeed, the cleavages implied by the competitiveness – vs – purchasing-power tradeoff map to interest groups only under an expansive definition of the concept (or, as above, when we introduce links to other policies). A class-based partisan approach is not much help, since the distributional effects of the real exchange rate on profits and wages cut across sector (tradables vs nontradables) and not factor (labor vs capital) lines. That is, a strong currency harms workers and capital employed in the traded goods sector and benefits factors engaged in the production of nontradables. There is thus little reason to believe that class-based political parties will find common ground on the preferred level of the exchange rate. More generally, the absence of class cleavages may distinguish currency level politics from currency regime politics.

Whatever the nature of interest group and partisan political pressures on the level of the exchange rate, elections and voting are likely to be of recurrent importance. A voluminous literature on “economic voting” provides robust support for the proposition that good macroeconomic conditions keep politicians in office whereas bad times cast them out (Lewis-Beck & Stegmaier 2000). The real exchange rate affects broad aggregates such as purchasing power, growth rates, and the price level – the stuff of national elections. Put another way, the macroeconomic effects of the real exchange rate may map closely to electoral processes, the broadest form of political aggregation.
Consumer/voters care about their purchasing power and inflation. Since voting is a low-cost activity, politicians are sure to be concerned with the electoral consequences of the exchange rate. Indeed, governments tend to maintain appreciated currencies before elections, delaying the necessary depreciation/devaluation until after the election (Klein & Marion 1997, Leblang 2000, Frieden et al 2001). An “exchange rate electoral cycle” gives a boost to voters’ income in the run-up to an election and imposes costs on voters only after the government is in office. The delay results in a depreciation that is larger (more costly) than if it had occurred immediately, but newly elected governments appear to follow the rule of “devalue immediately and blame it on your predecessors” (Edwards 1994).

The role of electoral cycles in exchange rate policy helps explain some characteristics of the currency crises that have been common over the past 20 years. Although the causes of currency crises are controversial (Corsetti et al 1998), delaying a devaluation certainly makes the problem worse. Given the expected political unpopularity of a devaluation-induced reduction in national purchasing power, however, governments may face strong incentives to avoid devaluing even when the result is a more severe crisis than would otherwise be expected. In Mexico, for example, the attempt to delay a devaluation of the peso until after the 1994 election almost certainly led to a far more drastic collapse of the currency than would have been the case without the electorally driven delay. As it became clear that the government was manipulating the exchange rate for political purposes, investors sold off the peso in droves, for the government’s exchange rate promises had lost all credibility. This run on the peso in turn called into question the credibility of other Latin American currency pegs, creating negative externalities for the region.

The electoral cycle is likely to be muted in countries where the central bank has sufficient insulation from political pressures or the government has a time horizon long enough to endogenize the higher costs of delayed action on the exchange rate. Where an independent central bank is in charge of exchange rate policy, the pursuit of price stability implies that politicians will be less able to manipulate the exchange rate for electoral purposes (Clark & Reichert 1998). Likewise, a government that expects to be in the majority across elections may have less incentive to exploit the short-term gains of real appreciation. The point is that political institutions condition the extent to which politicians have the capacity and/or the incentive to act on their short-run electoral goals, at the expense of macroeconomic stability and the competitiveness of their economies (Henning 1994).
The real exchange rate has international as well as domestic distributional consequences and thus plays an important role in international economic policy making. Increasing the competitiveness of the domestically produced goods sector by depreciating the currency necessarily means reducing the competitiveness of foreign goods. The use of the exchange rate to gain a competitive advantage, of course, cannot work when other countries retaliate with similar depreciations, as happened during the Great Depression. This is but one of many instances in which the domestic impact of national currency policy depends on the character of interstate monetary relations. This implies a direct connection between national exchange rate policies and the state of the international monetary system, to which we now turn.

The above analysis of national policies has left aside the important question of how to explain the development of global or regional monetary systems. Perhaps more than any other economic area, national exchange rate policies depend on those of other nations. This is certainly true with regard to the level of the nominal exchange rate, which is after all only meaningful in relationship to other countries’ nominal exchange rates. Another basic limitation of national analyses is that they do not take into account the nature of the international monetary system. This is especially the case when countries are faced with the choice of a fixed or flexible regime for national currencies, since fixing is a fundamentally different enterprise in the context of a global fixed-rate system than in the context of generalized floating. In the former case, such as under the gold standard or Bretton Woods, choosing whether or not to fix was tantamount to choosing whether or not to participate in a worldwide monetary order. A similar consideration applies to broad regional fixed-rate arrangements, such as the various monetary integration schemes of the European Union after 1973, or the Latin and Scandinavian monetary unions before 1914. Conversely, when the world monetary system is one of floating currencies, a national choice to fix the exchange rate is principally available to small countries that want to lock their currencies into step with their principal trading and investment partner, as many small Caribbean countries have done with the United States for decades. Especially given the analytical and empirical importance of international fixed-rate systems, it is important to investigate the reasons for their origins and evolution.

Generally speaking, three interrelated factors affect the evolution of international monetary systems. The first are the sorts of national policy choices discussed above, especially in the principal members of the system. The second are global economic factors that may affect global
monetary relations, such as trends in the international economy (growth, stagnation, crisis) and the state of international trade and payments. Third are purposive relations among states, including strategic interaction among governments, driven by their national concerns and constrained by the international environment.

In this section, we focus on this third set of factors, the interaction among states’ international monetary policies. Such interaction can be thought of as involving coordination among national government policies and/or cooperation among them, which is more complex. By coordination, we mean interaction among governments whose principal challenge is for national policies to converge on a focal point, for which the mutual adjustment of policies is unnecessary – such as simply choosing to link national currencies to gold or to the dollar. This implies the existence of a Pareto-improving Nash equilibrium (often more than one), as is the case in a Battle of the Sexes game – countries benefit from choosing the same currency regime, although there may be disagreement over which one to choose. By cooperation, we mean interaction in which national policies must be adjusted consciously to support each other – such as joint intervention in currency markets to support mutually agreed-on exchange rates. This implies the existence of a Pareto-inferior Nash equilibrium, which can be improved on (i.e. to a Nash bargaining solution), as is the case in a Prisoners’ Dilemma game – countries can work together to improve their collective and individual welfare. The two problems are not mutually exclusive, or even strikingly different; indeed, the resolution of one usually presupposes the resolution of the other. But for purposes of analysis it is helpful to separate the idea of a fixed-rate system as a focal point, for example, from the idea that its sustainability requires deliberately cooperative policies.

Coordination in International Monetary Relations

An international or regional fixed-rate regime, such as the gold standard or the European Monetary System, has important characteristics of a focal point around which national choices can be coordinated (Frieden 1993). As a focal point, a fixed-rate system can be self-reinforcing; the more countries that were on gold, or that tied their currencies to the Deutsche mark, the greater the incentive for other countries with significant commercial and financial ties to go down this path. Coordination here is particularly important as an ever larger monetarily integrated trading and investment area provides ever greater opportunities to other countries that might consider joining. This can be the case even
if the motivations of countries differ. One might particularly appreciate the monetary stability of a fixed rate, another the reduction in currency volatility. It does not matter, so long as the attractions of the regime increase with its membership (Broz 1997).

Most fixed-rate regimes do appear to grow in this way. This was certainly the case of the pre-1914 gold standard, which owed its start to the centrality of gold-standard Britain to the nineteenth-century international economy and owed its eventual global reach to the gradual accession of other major industrial nations to the British-led system. The same kind of growth characterized the process of European monetary integration, in which the Deutsche mark zone of Germany, Benelux, and Austria gradually attracted more and more European members. It should be noted, however, that just as the focal nature of a fixed-rate system can lead to a “virtuous circle” as more and more countries sign on, so too can the unraveling of the regime lead to a “vicious circle”. The departure of any important commercial or financial centers from the system can dramatically reduce its centripetal pull, as was the case with the collapse of the gold standard in the 1930s. Britain’s exit began a stampede that led virtually the entire rest of the world off gold within a couple of years. To some extent, then, the gold standard, Bretton Woods, and other such international and regional monetary regimes represent simple solutions to a coordination problem.

**Cooperation in International Monetary Relations**

International monetary relations may require more than simple convergence around a visible anchor and indeed may call for the resolution of more serious problems of cooperation. In other words, fixed-rate systems may only be stable when governments actively choose to cooperate with one another. A fixed-rate system may, in fact, give governments incentives to cheat, such as to devalue for competitive purposes while taking advantage of other countries’ commitment to monetary and currency stability. Such a system would not be stable should such free riding overcome attempts at coordination. By the same token, even a system as simple as the gold standard might have relied on explicit or implicit agreements among central gold currency countries to support each others’ monetary authorities in times of difficulty. An enduring monetary system, in this view, thus requires explicit cooperation at least among its principal members.

The problem is a familiar one, in which there are international gains from cooperation but potential national costs. It is useful to identify
explicitly both the welfare gain associated with international collaboration and the issues over which nations are likely to disagree. In the international monetary realm, the gains from a stable system of fixed rates are several. First, reduced currency volatility almost certainly increases the level of international trade and investment. Second, fixed rates tend to stabilize domestic monetary conditions, so that international monetary stability reinforces (and may even increase) domestic monetary stability. Third, predictable currency values can reduce international trade conflicts – for a rapid change in currency values, particularly the appreciation of one currency against others, often leads to an import surge, then protectionist pressures, and eventually commercial antagonism.

But, as discussed above, commitment to a fixed exchange rate has costs, and the form of the international monetary regime affects these costs. The principal cost is that the government cannot use the exchange rate to affect the domestic economy; it must, so to speak, adjust the economy to fit the exchange rate. The most common source of international conflict in this regard has to do with the international distribution of adjustment costs. For example, under Bretton Woods and the European Monetary System, one country’s currency served as the system’s anchor or key currency. This forced other countries to adapt their monetary policies to the anchor country’s and led to pressures from the other governments on the key-currency government to bring its policy more in line with conditions elsewhere. Under Bretton Woods, from the late 1960s until the system collapsed, European governments wanted the United States to implement more restrictive policies to bring down American inflation, while the US government refused. In the European Monetary System in the early 1990s, governments in the rest of the European Union wanted the Germans to implement less restrictive policies to combat the European recession, but the German central bank refused. This conflict between the attempts of the anchor country and others to shift the burden of adjustment has been a common theme of international and regional currency systems and the source of much acrimony. Generally speaking, closer countries come to agreement about the distribution of the costs of adjustment, the more likely they are to create and sustain a common fixed-rate regime (on closely related problems of international macroeconomic policy coordination, see Espinosa & Yip 1993).

Historical analyses tend to support the idea that the success or failure of intergovernmental cooperation has been crucial to the durability of fixed-rate international and regional monetary systems. Eichengreen’s (1992) magisterial study of the interwar gold standard points explicitly to
the centrality of international cooperation based on credible domestic political support. Such cooperative activities might include lending by the Bank of France to the Bank of England in the event of pressure on the pound sterling or the coordination of monetary policy measures in a time of international financial distress. Credible cooperation among the major powers before 1914 was the foundation stone of the classical gold standard, according to Eichengreen, and its absence explains the failure of the feeble interwar attempts to revive the gold standard. Many regional monetary unions, too, seem to obey this logic. Where political and other factors have encouraged cooperative behavior to safeguard the common commitment to fixed exchange rates, the systems have endured, but in the absence of these cooperative motives, they have decayed (Cohen 2001).

This raises the question of what stimulates cooperation on exchange rate issues. Cooperation is stimulated within the specifics of international monetary relations by much the same factors as elsewhere in international politics (Willett 1999, Simmons 2000). One factor is a shared interest in currency stability. A major reason for the collapse of the Bretton Woods system was that American policy makers simply were much less concerned about the effects of exchange rate volatility than Europeans were. A second factor is linkage to other policies. The existence of cooperative ventures outside the monetary realm can stimulate currency cooperation. It is in fact doubtful that Economic Monetary Union (EMU) would have been possible had it not been part of a broader process of European integration (Garrett 2001, Martin 2001). A third, often related, factor is the institutionalized nature of interstate cooperation. Formal or informal mechanisms for governments to work out their monetary differences appear to be associated with greater cooperation. A fourth factor is numbers – the presence of a small group of large states willing and able to take the lead in monetary relations has been common to most successful fixed-rate orders, whether during the gold standard, Bretton Woods, or any number of regional systems. A final factor is environmental economic conditions. Most cooperative monetary arrangements have been sorely taxed by recurrent or protracted macroeconomic downturns.

It should be kept in mind that the relevant level of international monetary cooperation in many instances may be regional rather than global. There have been at least three distinctive global monetary regimes, whose emergence, evolution, and demise are all worth explaining. But there have been many more formal or informal regional monetary regimes, and they have had varying degrees of success, from the Latin
Monetary Union of the nineteenth century to the East African Community of the 1960s and 1970s. Proposals for new regional currency arrangements have proliferated in recent years, with the successful establishment of EMU the most prominent example. Analysis of such international monetary ventures requires attention to the focal-point nature of fixed-rate systems, to the welfare gains such a system provides and the distributional effects it implies, and to the factors widely understood to affect interstate cooperation more generally.

Two of the most recent such regime-related topics, EMU in Europe and ongoing debates over dollarization in Latin America, illustrate the operation of these international factors. Dollarization appears to raise ideal-typical coordination issues, as national governments consider independent choices to adopt the US dollar. The United States has indeed explicitly ruled out any meaningful cooperation with dollarizing governments. The principal attraction for potential dollarizers is association with large and dynamic dollar-based capital and goods markets; and the more countries dollarize, the greater this attraction will be. On the other hand, although the course of EMU from 1973 to completion did have features of a focal point, especially in the operation of the European Monetary System as a Deutsche mark bloc, the more complex bargained resolution of the transition to EMU went far beyond this. This bargaining solution involved mutual, indeed unanimous, agreement on the structure of the new European Central Bank, the national macroeconomic policies necessary for membership in the monetary union, and a host of other considerations. These difficult bargains were unquestionably made much easier by the small number of central players (arguably only Germany and France), the highly institutionalized EU environment, and the complex network of policy linkages between EMU and other European initiatives.

Until recently, scholarly analysis of the political economy of national exchange rate policies and of international monetary relations lagged far behind their political and economic importance. Over the past decade, however, substantial progress has been made in understanding why governments pursue the currency policies they do, and why regional and international currency regimes emerge and evolve. Many of these advances build on preexisting work on the political economy of international trade and investment, but others come specifically from the study of international monetary politics.

At the domestic level, we now have a reasonably well-developed set of arguments about the economic interests at stake and about how political institutions affect currency policy choice. The theoretical and empirical
status of these arguments remains undecided, but together they constitute an emerging body of scholarship with clear dependent and candidate explanatory variables. At the international level, the study of global and regional monetary regimes has incorporated developments in the analysis of international cooperation, using them to explain the ebb and flow of such systems over the past two centuries.

Future research on the political economy of international monetary relations has to confront several challenges. First, it needs to clarify and work toward resolution of the various theoretical and empirical ambiguities in existing scholarship. Second, it needs to work toward an integration of the international and domestic sources and effects of exchange rate policy, for the two are integrally interrelated. Third, in concert with research in other areas of political economy, it needs to incorporate the impact of such closely related issue areas as trade and financial policy on international monetary affairs. These are substantial challenges, but the past decade has seen impressive progress in the study of international monetary policy, and there is no reason to doubt that the coming decades will be just as fruitful.

Questions for self-control

1. What are the current views on the content of foreign economic activity?
2. Describe the main forms and types of foreign economic activity.
3. Describe the concept of "foreign economic activity".
4. When did this concept first appear?
5. What is the relationship between the concepts of foreign economic activity and foreign trade activity?
6. When did the reforms in the foreign economic sphere of Russia begin?
7. What is the essence of these reforms?
8. Was the state monopoly on foreign trade liquidated in Russia?
9. Describe the main stages of reform.
10. What is the country’s foreign economic complex (VEC)?
11. What are the features and prospects of the VEC of Russia?
2. BALANCES OF INTERNATIONAL SETTLEMENTS

Official Settlement Account

An official settlement account is a special type of account used in international balance of payments (BoP) accounting to keep track of central banks’ reserve asset transactions with one other. The official settlement account keeps track of transactions involving gold, foreign exchange reserves, bank deposits and special drawing rights (SDRs).

Essentially, this type of account keeps track of transactions related to international reserves and central bank assets that are transferred among nations to settle either a balance of payment deficit or surplus.

Official settlement accounts are used in international balance of payments accounting, and represent the current account and the capital account of central banks. The current account keeps a record of a country’s imports and exports of goods, services, income and transfers, and whether the country is a net creditor or net debtor. The capital account records the change in foreign and domestic investments, government borrowing and private sector borrowing. When there is either a balance of payments deficit or surplus, inflows of reserve assets or outflows of reserve assets bring the ledger back into balance. This is recorded in the official settlement account.

The Bank for International Settlements (BIS) is an international financial institution that aims to promote global monetary and financial stability and maintains oversight of official settlement accounts. The BIS is sometimes called the “central bank for central banks” because it provides banking services to institutions such as the European Central Bank and Federal Reserve.

Monitoring an Official Settlement Account

Nations keep an eye on the official settlement account to gauge their economic health in the global economy. If there are continual outflows of reserve assets for a country, it means that its competitiveness in producing exported goods is relatively weak, or it’s business environment is not as attractive as that offered by other countries for direct foreign investment.

A nation running chronic current account deficits may then formulate policy prescriptions to improve the quality of its goods for export or seek exchange rate adjustments to make their exports more price competitive. It also may try to create better conditions for international companies looking to build new factories abroad. Tax incentives, infrastructure projects, and workforce training programs could be promoted by a country to address unwanted outflows recorded in its official settlement account.
Understanding the Balance of Payments (BOP)

The balance of payments (BOP), also known as balance of international payments, summarizes all transactions that a country’s individuals, companies, and government bodies complete with individuals, companies, and government bodies outside the country. These transactions consist of imports and exports of goods, services, and capital, as well as transfer payments, such as foreign aid and remittances.

A country’s balance of payments and its net international investment position together constitute its international accounts.

The balance of payments divides transactions in two accounts: the current account and the capital account. Sometimes the capital account is called the financial account, with a separate, usually very small, capital account listed separately. The current account includes transactions in goods, services, investment income, and current transfers. The capital account, broadly defined, includes transactions in financial instruments and central bank reserves. Narrowly defined, it includes only transactions in financial instruments. The current account is included in calculations of national output, while the capital account is not.

The sum of all transactions recorded in the balance of payments must be zero, as long as the capital account is defined broadly. The reason is that every credit appearing in the current account has a corresponding debit in the capital account, and vice-versa. If a country exports an item (a current account transaction), it effectively imports foreign capital when that item is paid for (a capital account transaction).

If a country cannot fund its imports through exports of capital, it must do so by running down its reserves. This situation is often referred to as a balance of payments deficit, using the narrow definition of the capital account that excludes central bank reserves. In reality, however, the broadly defined balance of payments must add up to zero by definition. In practice, statistical discrepancies arise due to the difficulty of accurately counting every transaction between an economy and the rest of the world, including discrepancies caused by foreign currency translations.

Economic Policy and the Balance of Payments

Balance of payments and international investment position data are critical in formulating national and international economic policy. Certain aspects of the balance of payments data, such as payment imbalances and foreign direct investment, are key issues that a nation’s policymakers seek to address.
Economic policies are often targeted at specific objectives that, in turn, impact the balance of payments. For example, one country might adopt policies specifically designed to attract foreign investment in a particular sector, while another might attempt to keep its currency at an artificially low level in order to stimulate exports and build up its currency reserves. The impact of these policies is ultimately captured in the balance of payments data.

**Imbalances Between Countries**

While a nation’s balance of payments necessarily zeroes out the current and capital accounts, imbalances can and do appear between different countries’ current accounts. According to the World Bank, the U.S. had the world’s largest current account deficit in 2019, at $498 billion. Germany had the world’s largest surplus, at $275 billion.

Such imbalances can generate tensions between countries. Donald Trump campaigned in 2016 on a platform of reversing the U.S.’s trade deficits, particularly with Mexico and China. The Economist argued in 2017 that Germany’s surplus “puts unreasonable strain on the global trading system”, since “to offset such surpluses and sustain enough aggregate demand to keep people in work, the rest of the world must borrow and spend with equal abandon”.

**History of the Balance of Payments (BOP)**

Prior to the 19th century, international transactions were denominated in gold, providing little flexibility for countries experiencing trade deficits. Growth was low, so stimulating a trade surplus was the primary method of strengthening a nation’s financial position. National economies were not well integrated with each other, however, so steep trade imbalances rarely provoked crises. The industrial revolution increased international economic integration, and balance of payment crises began to occur more frequently.

The Great Depression led countries to abandon the gold standard and engage in competitive devaluation of their currencies, but the Bretton Woods system that prevailed from the end of World War II until the 1970s introduced a gold-convertible dollar with fixed exchange rates to other currencies. As the U.S. money supply increased and its trade deficit deepened, however, the government became unable to fully redeem foreign central banks’ dollar reserves for gold, and the system was abandoned.

Since the Nixon shock – as the end of the dollar’s convertibility to gold is known – currencies have floated freely, meaning that country
experiencing a trade deficit can artificially depress its currency – by hoarding foreign reserves, for example – making its products more attractive and increasing its exports. Due to the increased mobility of capital across borders, balance of payments crises sometimes occur, causing sharp currency devaluations such as the ones that struck in Southeast Asian countries in 1998.

During the Great Recession several countries embarked on competitive devaluation of their currencies to try to boost their exports. All of the world’s major central banks responded to the financial crisis at the time by executing dramatically expansionary monetary policy. This led to other nations’ currencies, especially in emerging markets, appreciating against the U.S. dollar and other major currencies. Many of those nations responded by further loosening the reins on their own monetary policy in order to support their exports, especially those whose exports were under pressure from stagnant global demand during the Great Recession.

**Special Drawing Rights (SDR)**

Special drawing rights (SDR) refer to an international type of monetary reserve currency created by the International Monetary Fund (IMF) in 1969 that operates as a supplement to the existing money reserves of member countries. Created in response to concerns about the limitations of gold and dollars as the sole means of settling international accounts, SDRs augment international liquidity by supplementing the standard reserve currencies.

**Understanding Special Drawing Rights (SDR)**

An SDR is essentially an artificial currency instrument used by the IMF and is built from a basket of important national currencies. The IMF uses SDRs for internal accounting purposes. SDRs are allocated by the IMF to its member countries and are backed by the full faith and credit of the member countries’ governments. The makeup of the SDR is re-evaluated every five years. The current makeup of the SDR is represented by the following table 1.

The SDR was formed with a vision of becoming a major element of international reserves, with gold and reserve currencies forming a minor incremental component of such reserves. This consisted of central bank or government reserves of gold and globally accepted foreign currencies that could be used to buy the local currency in foreign exchange markets to maintain a stable exchange rate.
However, the international supply of the U.S. dollar and gold – the two main reserve assets – wasn’t sufficient to support growth in global trade and the related financial transactions that were taking place. This prompted member countries to form an international reserve asset under the guidance of the IMF.

Table 1

<table>
<thead>
<tr>
<th>Currency</th>
<th>Weights determined in the 2015 review</th>
<th>Fixed number of units of currency for a 5-year period starting oct. 1, 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Dollar</td>
<td>41.73</td>
<td>0.58252</td>
</tr>
<tr>
<td>Euro</td>
<td>30.93</td>
<td>0.38671</td>
</tr>
<tr>
<td>Chinese Yuan</td>
<td>10.92</td>
<td>1.0174</td>
</tr>
<tr>
<td>Japanese Yen</td>
<td>8.33</td>
<td>11.900</td>
</tr>
<tr>
<td>Pound Sterling</td>
<td>8.09</td>
<td>0.085946</td>
</tr>
</tbody>
</table>

In 1973, a few years after the SDR was created, the Bretton Woods system imploded, moving major currencies to the floating exchange rate system [3]. In time, international capital markets expanded considerably, enabling creditworthy governments to borrow funds. This saw many governments register exponential growth in their international reserves. These developments diminished the stature of the SDR as a global reserve currency.

Besides acting as an auxiliary reserve asset, and though its stature has diminished, the SDR is the unit of account for the IMF. Its value, which is summed up in U.S. dollars, is calculated from a weighted basket of major currencies: the Japanese yen, the U.S. dollar, the Chinese yuan, the pound sterling, and the euro.

Requirements of Special Drawing Rights (SDR)
The current requirements to be included in the SDR were established in 2000.

The Board states that the SDR basket is to comprise of the currencies of “members or monetary unions whose exports had the largest value over a five-year period, and have been determined by the IMF to be freely usable”.

“Freely usable”, according to the IMF, is a currency that “(i) is, in fact, widely used to make payments for international transactions, and (ii) is widely traded in the principal exchange markets”.

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Determining what is “freely usable” is gauged on metrics such as the number of shares of the currency in reserve holdings, the currency denomination of international debt securities, the volume of transactions in foreign exchange markets, cross border payments, and trade finance.

**Using the Concept of Special Drawing Rights (SDR) to Settle Claims**

The SDR isn’t regarded as a currency or a claim against the IMF assets. Instead, it is a prospective claim against the freely usable currencies that belong to the IMF member states. The Articles of Agreement of the IMF define a freely usable currency as one that is widely used in international transactions and is frequently traded in foreign exchange markets.

The IMF member states that hold SDRs can exchange them for freely usable currencies by either agreeing among themselves to voluntary swaps or by the IMF instructing countries with stronger economies or larger foreign currency reserves to buy SDRs from the less-endowed members. IMF member countries can borrow SDRs from its reserves at favorable interest rates, mostly to adjust their balance of payments to favorable positions.

**The Special Drawing Rights (SDR) Interest Rate**

The interest rate on SDRs, or the SDRi, provides the basis for calculating the interest rate that is charged to member countries when they borrow from the IMF and paid to members for their remunerated creditor positions in the IMF. It is also the interest paid to member countries on their own SDR holdings and charged on their SDR allocation.

The SDRi is determined weekly based on a weighted average of representative interest rates on short-term government debt instruments in the money markets of the SDR basket currencies, with a floor of five basis points. It is posted on the IMF website.

**Understanding the Current Account**

The current account is one half of the balance of payments, the other half being the capital account. While the capital account measures cross-border investments in financial instruments and changes in central bank reserves, the current account measures imports and exports of goods and services, payments to foreign holders of a country’s investments, payments received from investments abroad, and transfers such as foreign aid and remittances. Some countries will split the capital account into two top-level divisions (i.e., the financial account and the capital account). In this
context, the financial account measures increases or decreases in international ownership of assets, while the capital account measures financial transactions that do not affect income, production, or savings.

A country’s current account balance may be positive (a surplus) or negative (a deficit); in either case the country’s capital account balance will register an equal and opposite amount. Exports are recorded as credits in the balance of payments, while imports are recorded as debits. In keeping with double-entry bookkeeping, any credit in the current account (such as an export) will have a corresponding debit recorded in the capital account. Essentially, the country "imports" the money that a foreign buyer pays for the export. The item received by the nation is recorded as a debit while the item given up in the transaction is recorded as a credit.

A positive current account balance indicates that the nation is a net lender to the rest of the world, while a negative current account balance indicates that it is a net borrower. A current account surplus increases a nation’s net foreign assets by the amount of the surplus, while a current account deficit decreases it by the amount of the deficit.

Factors Affecting the Current Account

Since the trade balance (exports minus imports) is generally the biggest determinant of the current account surplus or deficit, the current account balance often displays a cyclical trend. During a strong economic expansion, import volumes typically surge; if exports are unable to grow at the same rate, the current account deficit will widen. Conversely, during a recession, the current account deficit will shrink if imports decline and exports increase to stronger economies.

The exchange rate exerts a significant influence on the trade balance, and by extension, on the current account. An overvalued currency makes imports cheaper and exports less competitive, thereby widening the current account deficit or narrowing the surplus. An undervalued currency, on the other hand, boosts exports and makes imports more expensive, thus increasing the current account surplus or narrowing the deficit.

Nations with chronic current account deficits often come under increased investor scrutiny during periods of heightened uncertainty. The currencies of such nations often come under speculative attack during such times. This creates a vicious circle in which foreign exchange reserves are depleted to support the domestic currency, and this foreign exchange reserve depletion – combined with a deteriorating trade balance – puts further pressure on the currency. Embattled nations are often forced to take stringent measures to support the currency, such as raising interest rates and curbing currency outflows.
**Capital Account**

The capital account, in international macroeconomics, is the part of the balance of payments which records all transactions made between entities in one country with entities in the rest of the world. These transactions consist of imports and exports of goods, services, capital, and as transfer payments such as foreign aid and remittances. The balance of payments is composed of a capital account and a current account – though a narrower definition breaks down the capital account into a financial account and a capital account. The capital account measures the changes in national ownership of assets, whereas the current account measures the country’s net income.

In accounting, the capital account shows the net worth of a business at a specific point in time. It is also known as owner’s equity for a sole proprietorship or shareholders’ equity for a corporation, and it is reported in the bottom section of the balance sheet.

**Reserve Assets**

Reserve assets are financial assets denominated in foreign currencies, held by central banks, that are primarily used to balance payments. A reserve asset must be readily available to monetary authorities, must be an external physical asset that is, in some measure, controlled by policymakers, and must be easily transferable.

**How Capital Accounts Work**

Changes in the balance of payments can provide clues about a country’s relative level of economic health and future stability. The capital account indicates whether a country is importing or exporting capital. Big changes in the capital account can indicate how attractive a country is to foreign investors and can have a substantial impact on exchange rates.

Because all the transactions recorded in the balance of payments sum to zero, countries that run large trade deficits (current account deficits), like the United States, [1] must by definition also run large capital account surpluses. This means more capital is flowing into the country than going out, caused by an increase in foreign ownership of domestic assets. A country with a large trade surplus is exporting capital and running a capital account deficit, which means money is flowing out of the country in exchange for increased ownership in foreign assets.

It is important to remember that the U.S. trade deficit is the consequence of foreign investors finding U.S. assets particularly attractive,
and driving up the value of the dollar. Should America’s relative appeal to foreign investors fade, the dollar would weaken and the trade deficit would shrink.

*Capital Account vs. Financial Account*

In recent years, many countries have adopted the narrower meaning of capital account used by the International Monetary Fund (IMF). It splits the capital account into two top-level divisions: the financial account and capital account. The capital and financial accounts measure net flows of financial claims (i.e., changes in asset position).

An economy’s stock of foreign assets versus foreign liabilities is referred to as its net international investment position, or simply net foreign assets, which measures a country’s net claims on the rest of the world. If a country’s claims on the rest of the world exceed their claims on it, then it has positive net foreign assets and is said to be a net creditor. If negative, a net debtor. The position changes over time as indicated by the capital and financial account.

The financial account measures increases or decreases in international ownership of assets, whether they be individuals, businesses, governments, or central banks. These assets include foreign direct investments, securities like stocks and bonds, and gold and foreign exchange reserves. The capital account, under this definition, measures financial transactions that do not affect income, production, or savings, such as international transfers of drilling rights, trademarks, and copyrights.

*Current vs. Capital Account*

The current and capital accounts represent two halves of a nation’s balance of payments. The current account represents a country’s net income over a period of time, while the capital account records the net change of assets and liabilities during a particular year.

In economic terms, the current account deals with the receipt and payment in cash as well as non-capital items, while the capital account reflects sources and utilization of capital. The sum of the current account and capital account reflected in the balance of payments will always be zero. Any surplus or deficit in the current account is matched and canceled out by an equal surplus or deficit in the capital account.

The current account deals with a country’s short-term transactions or the difference between its savings and investments. These are also referred to as actual transactions (as they have a real impact on income), output,
and employment levels through the movement of goods and services in the economy. The current account consists of visible trade (export and import of goods), invisible trade (export and import of services), unilateral transfers, and investment income (income from factors such as land or foreign shares).

The credit and debit of foreign exchange from these transactions are also recorded in the balance of current account. The resulting balance of the current account is approximated as the sum total of balance of trade.

**Capital Accounts in Accounting**

In accounting, a capital account is a general ledger account that is used to record the owners’ contributed capital and retained earnings – the cumulative amount of a company’s earnings since it was formed, minus the cumulative dividends paid to the shareholders. It is reported at the bottom of the company’s balance sheet, in the equity section. In a sole proprietorship, this section would be referred to as owner’s equity and in a corporation, shareholder’s equity.

In a corporate balance sheet, the equity section is usually broken down into common stock, preferred stock, additional paid-in capital, retained earnings, and treasury stock accounts. All of the accounts have a natural credit balance, except for treasury stock that has a natural debit balance. Common and preferred stock are recorded at the par value of total shares owned by shareholders. Additional paid-in capital is the amount shareholder’s have paid into the company in excess of the par value of stock. Retained earnings is the cumulative earnings of the company overtime, minus dividends paid out to shareholders, that have been reinvested in the company’s ongoing business operations. The treasury stock account is a contra equity account that records a company’s share buybacks.

**Questions for self-control**

1. What are the main directions of modern international commercial activity and what are the features of each of them?
2. How can you define the concept of “international trade transaction”?
3. What international document is fundamental for the conclusion of international sales contracts?
4. How are the concepts of “foreign trade transactions” and “foreign trade operations” interconnected?
5. What is the main specificity of re-export transactions?
6. What types of barter transactions are found in international trade?
7. What transactions in the field of services are the main ones, and what are the servicing ones?
8. What is the difference between a financed leasing transaction and an operational one?
9. What is included in the concept of “integrated engineering services”?
10. What is the peculiarity of the results of scientific and technical developments as an object of international reporting trade: to get a ball?
3. EXCHANGE RATE

In finance, an exchange rate is the rate at which one national currency will be exchanged for another. It is also regarded as the value of one country’s currency in relation to another currency [10]. For example, an interbank exchange rate of 114 Japanese yen to the United States dollar means that ¥114 will be exchanged for US$1 or that US$1 will be exchanged for ¥114. In this case it is said that the price of a dollar in relation to yen is ¥114, or equivalently that the price of a yen in relation to dollars is $1/114.

Each country determines the exchange rate regime that will apply to its currency. For example, a currency may be floating, pegged (fixed), or a hybrid. Governments can impose certain limits and controls on exchange rates.

In floating exchange rate regimes, exchange rates are determined in the foreign exchange market, which is open to a wide range of different types of buyers and sellers, and where currency trading is continuous: 24 hours a day except weekends (i.e. trading from 20:15 GMT on Sunday until 22:00 GMT Friday). The spot exchange rate is the current exchange rate, while the forward exchange rate is an exchange rate that is quoted and traded today but for delivery and payment on a specific future date.

In the retail currency exchange market, different buying and selling rates will be quoted by money dealers. Most trades are to or from the local currency. The buying rate is the rate at which money dealers will buy foreign currency, and the selling rate is the rate at which they will sell that currency. The quoted rates will incorporate an allowance for a dealer’s margin (or profit) in trading, or else the margin may be recovered in the form of a commission or in some other way. Different rates may also be quoted for cash, a documentary transaction or for electronic transfers. The higher rate on documentary transactions has been justified as compensating for the additional time and cost of clearing the document. On the other hand, cash is available for resale immediately, but incurs security, storage, and transportation costs, and the cost of tying up capital in a stock of banknotes (bills).

Currency for international travel and cross-border payments is predominantly purchased from banks, foreign exchange brokerages and various forms of bureaux de change [citation needed]/ These retail outlets source currency from the interbank markets, which are valued by the Bank for International Settlements at US$5.3 trillion per day. The purchase is made at the spot contract rate. Retail customers will be
charged, in the form of commission or otherwise, to cover the provider’s costs and generate a profit. One form of charge is the use of an exchange rate that is less favourable than the wholesale spot rate. The difference between retail buying and selling prices is referred to as the bid–ask spread.

*Exchange rates display in Thailand*

There is a market convention that rules the notation used to communicate the fixed and variable currencies in a quotation. For example, in a conversion from EUR to AUD, EUR is the fixed currency, AUD is the variable currency and the exchange rate indicates how many Australian dollars would be paid or received for 1 Euro. 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 some areas of Europe and in the retail market in the United Kingdom, EUR and GBP are reversed so that GBP is quoted as the fixed currency to the euro. In order to determine which is the fixed currency when neither currency is on the above list (i.e. both are “other”), market convention is to use the fixed currency which gives an exchange rate greater than 1.000. This reduces rounding issues and the need to use excessive numbers of decimal places. There are some exceptions to this rule: for example, the Japanese often quote their currency as the base to other currencies.

Quotation using a country’s home currency as the price currency is known as direct quotation or price quotation (from that country’s perspective) [clarification needed]. For example, EUR 0.8989 = USD 1.00 in the Eurozone and is used in most countries.

Quotation using a country’s home currency as the unit currency [clarification needed] (for example, US$1.11 = EUR 1.00 in the Eurozone) is known as indirect quotation or quantity quotation and is used in British newspapers; it is also common in Australia, New Zealand and the Eurozone.

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 1980s to 2006 was that most currency pairs were quoted to four decimal places for spot transactions and up to six decimal places for forward outrights 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 1.000 which were usually quoted to five or six decimal places. 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 5000 were usually quoted with no decimal places (for example, the former Turkish Lira). e.g. (GBPOMR : 0.765432 - : 1.4436 – EURJPY : 165.29). In other words, quotes are given with five digits. Where rates are below 1, quotes frequently include five decimal places.

In 2005, Barclays Capital broke with convention by quoting spot exchange rates with five or six decimal places on their electronic dealing platform. The contraction of spreads (the difference between the bid and ask rates) arguably necessitated finer pricing and gave the banks the ability to try and win transactions on multibank trading platforms where all banks may otherwise have been quoting the same price. A number of other banks have now followed this system.

Exchange rate regime

Main article: Exchange rate regime

Countries are free to choose which type of exchange rate regime they will apply to their currency. The main types of exchange rate regimes are: free-floating, pegged (fixed), or a hybrid.

In free-floating regimes, exchange rates are allowed to vary against each other according to 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. For example, between 1994 and 2005, the Chinese yuan renminbi (RMB) was pegged to the United States dollar at RMB 8.2768 to $1. China was not the only country to do this; from the end of World War II until 1967, Western European countries all maintained fixed exchange rates with the US dollar based on the Bretton Woods system. But that system had to be abandoned in favor of floating, market-based regimes due to market pressures and speculation, according to President Richard M. Nixon in a speech on August 15, 1971, 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

From the perspective of bank foreign exchange trading

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. In general, the exchange rate where the foreign currency is converted to a smaller number of domestic currencies is the buying rate, which indicates how much the country’s currency is required to buy a certain amount of foreign exchange.

Selling rate: 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 indicates how much the country’s currency needs to be recovered if the bank sells a certain amount of foreign exchange.

Middle rate: 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

Spot exchange rate: 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.

Forward exchange rate: To 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 exchange risk. The forward exchange rate is based on the spot exchange rate, which is represented by the “premium”, “discount”, and “parity” of the spot exchange rate.

According to the method of setting the exchange rate

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.
Cross rate: 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.

**Other classifications:**
- According to the payment method in foreign exchange transactions
- Telegraphic exchange rate
- Mail transfer rate
- Demand draft rate

*According to the level of foreign exchange controls*

Official rate: The official exchange rate is the rate of exchange announced by a country’s foreign exchange administration. Usually used by countries with strict foreign exchange controls.

Market rate: 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*

Fixed exchange rate: It means that the exchange rate between a country’s currency and another country’s currency is basically fixed, and the fluctuation of exchange rate is very small.

Floating exchange rate: It means that the monetary authorities of a country do not stipulate the official exchange rate of the country’s currency against other currencies, nor does it have any upper or lower limit of exchange rate fluctuations. 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 inflation is included*

Nominal exchange rate: an exchange rate that is officially announced or marketed which does not consider inflation.

Real exchange rate: The nominal exchange rate eliminating inflation

*Factors affecting the change of exchange rate*

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.

Fiscal and monetary policy: Although the influence of monetary policy on the exchange rate changes of a country’s government is indirect, it is also very important. 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 fall. Speculation is an important factor in the short-term fluctuations in the exchange rate of the foreign exchange market.

Government market intervention: When exchange rate fluctuations in the foreign exchange market adversely affect a country’s economy, trade, or the government needs to achieve certain policy goals through exchange rate adjustments, monetary authorities can participate in currency trading, buying or selling local or foreign currencies in large quantities in the market. The foreign exchange supply and demand has caused the exchange rate to change.

Economic strength of a country: In general, high economic growth rates are not conducive to the local currency’s performance in the foreign exchange market in the short term, but in the long run, they strongly support the strong momentum of the local currency.

Emerging markets
Research on target zones has mainly concentrated on the benefit of stability of exchange rates for industrial countries, but some studies have argued that volatile bilateral exchange rates between industrial countries are in part responsible for financial crisis in emerging markets. According
to this view the ability of emerging market economies to compete is weakened because many of the currencies are tied to the US dollar in various fashions either implicitly or explicitly, so fluctuations such as the appreciation of the US dollar to the yen or deutsche Mark have contributed to destabilizing shocks. Most of these countries are net debtors whose debt is denominated in one of the G3 currencies.

In September 2019 Argentina restricted the ability to buy US dollars. Mauricio Macri in 2015 campaigned on a promise to lift restrictions put in place by the left-wing government including the capital controls which have been used in Argentina to manage economic instability. When inflation rose above 20 percent transactions denominated in dollars became commonplace as Argentinians moved away from using the peso. In 2011 the government of Cristina Fernández de Kirchner restricted the purchase of dollars leading to a rise in black market dollar purchases. The controls were rolled back after Macri took office and Argentina issued dollar denominated bonds, but when various factors led to a loss in the value of the peso relative to the dollar leading to the restoration of capital controls to prevent additional depreciation amidst peso selloffs.

*Fluctuations in exchange rates*

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 transaction demand is highly correlated to a country’s level of business activity, gross domestic product (GDP), and employment levels. 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. In general, the higher a country’s interest rates, the greater will be the demand for that currency. It has been argued [by whom?] that such speculation can undermine real economic growth, in particular since
large currency speculators may deliberately create downward pressure on a currency by shorting in order to force that central bank to buy their own currency to keep it stable. (When that happens, the speculator can buy the currency back after it depreciates, close out their position, and thereby make a profit.) [citation needed]

For carrier companies shipping goods from one nation to another, exchange rates can often impact them severely. Therefore, most carriers have a CAF charge to account for these fluctuations.

**Purchasing power of currency**

The real exchange rate (RER) is the purchasing power of a currency relative to another at current exchange rates and prices. It is the ratio of the number of units of a given country’s currency necessary to buy a market basket of goods in the other country, after acquiring the other country’s currency in the foreign exchange market, to the number of units of the given country’s currency that would be necessary to buy that market basket directly in the given country. There are various ways to measure RER.

Thus the real exchange rate is the exchange rate times the relative prices of a market basket of goods in the two countries. For example, the purchasing power of the US dollar relative to that of the euro is the dollar price of a euro (dollars per euro) times the euro price of one unit of the market basket (euros/goods unit) divided by the dollar price of the market basket (dollars per goods unit), and hence is dimensionless. 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 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**

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. More in detail, an appreciation of the currency or a high level of domestic inflation reduces the RER, thus reducing the country’s competitiveness and lowering the Current Account (CA). On the other hand, a currency depreciation generates an opposite effect, improving the country’s CA.

There is evidence that the RER generally reaches a steady level in the long-term, and that this process is faster in small open economies characterized by fixed exchange rates. Any substantial and persistent RER deviation from its long-run equilibrium level, the so-called RER misalignment, has shown to produce negative impacts on a country’s balance of payments. An overvalued RER means that the current RER is above its equilibrium value, whereas an undervalued RER indicates the contrary. Specifically, a prolonged RER overvaluation is widely considered as an early sign of an upcoming crisis, due to the fact that the country becomes vulnerable to both speculative attacks and currency crisis, as happened in Thailand during the 1997 Asian financial crisis. On the other side, a protracted RER undervaluation usually generates pressure on domestic prices, changing the consumers’ consumption incentives and, so, misallocating resources between tradable and non-tradable sectors.

Given that RER misalignment and, in particular overvaluation, can undermine the country’s export-oriented development strategy, the equilibrium RER measurement is crucial for policymakers. Unfortunately, this variable cannot be observed. The most common method in order to estimate the equilibrium RER is the universally accepted Purchasing Power Parity (PPP) theory, according to which the RER equilibrium level is assumed to remain constant over time. Nevertheless, the equilibrium RER is not a fixed value as it follows the trend of key economic fundamentals, such as different monetary and fiscal policies or asymmetrical shocks between the home country and abroad. Consequently, the PPP doctrine has been largely debated during the years, given that it may signal a natural RER movement towards its new equilibrium as a RER misalignment.

Starting from the 1980s, in order to overcome the limitations of this approach, many researchers tried to find some alternative equilibrium RER measures. Two of the most popular approaches in the economic literature are the Fundamental Equilibrium Exchange Rate (FEER), developed by Williamson (1994), and the Behavioural Equilibrium Exchange Rate (BEER), initially estimated by Clark and MacDonald (1998). The FEER focuses on long-run determinants of the RER, rather than on short-term cyclical and speculative forces. It represents a RER consistent with
macroeconomic balance, characterized by the achievement of internal and external balances at the same time. 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. On the other hand, external balance holds when actual and future CA balances are compatible with long-term sustainable net capital flows. Nevertheless, the FEER is viewed as a normative measure of the RER since it is based on some “ideal” economic conditions related to internal and external balances. Particularly, since the sustainable CA position is defined as an exogenous value, this approach has been broadly questioned over time. By contrast, the BEER entails an econometric analysis of the RER behaviour, considering significant RER deviations from its PPP equilibrium level as a consequence of changes in key economic fundamentals. According to this method, the BEER is the RER that results when all the economic fundamentals are at their equilibrium values. Therefore, the total RER misalignment is given by the extent to which economic fundamentals differ from their long-run sustainable levels. In short, the BEER is a more general approach than the FEER, since it is not limited to the long-term perspective, being able to explain RER cyclical movements.

Bilateral vs. effective exchange rate

Example of GNP-weighted nominal exchange rate history of a basket of 6 important currencies (US Dollar, Euro, Japanese Yen, Chinese Renminbi, Swiss Franks, Pound Sterling).

Bilateral exchange rate involves a currency pair, while an effective exchange rate is a weighted average of a basket of foreign currencies, and it can be viewed as an overall measure of the country’s external competitiveness. A nominal effective exchange rate (NEER) is weighted with the inverse of the asymptotic trade weights. A real effective exchange rate (REER) adjusts NEER by appropriate foreign price level and deflates by the home country price level. Compared to NEER, a GDP weighted effective exchange rate might be more appropriate considering the global investment phenomenon.

Parallel exchange rate

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.
Uncovered interest rate parity

Uncovered interest rate parity (UIRP) states that an appreciation or depreciation of one currency against another currency might be neutralized by a change in the interest rate differential. 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 1990s. Contrary to the theory, currencies with high interest rates characteristically appreciated rather than depreciated on the reward of the containment of inflation and a higher-yielding currency.

Balance of payments model. The balance of payments model holds that foreign exchange rates are at an equilibrium level if they produce a stable Current account (balance of payments) current account balance. A nation with a trade deficit will experience a reduction in its foreign exchange reserves, which ultimately lowers (depreciates) the value of its currency. A cheaper (undervalued) currency renders the nation’s goods (exports) more affordable in the global market while making imports more expensive. After an intermediate period, imports will be forced down and exports to rise, thus stabilizing the trade balance and bring the currency towards equilibrium.

Like purchasing power parity, the balance of payments model focuses largely on tradeable goods and services, ignoring the increasing role of global capital flows. In other words, money is not only chasing goods and services, but to a larger extent, financial assets such as stocks and bonds. Their flows go into the capital account item of the balance of payments, thus balancing the deficit in the current account. The increase in capital flows has given rise to the asset market model effectively.

Asset market model

The increasing volume of trading of financial assets (stocks and bonds) has required a rethink of its impact on exchange rates. Economic variables such as economic growth, inflation and productivity are no longer the only drivers of currency movements. The proportion of foreign exchange transactions stemming from cross border-trading of financial
assets has dwarfed the extent of currency transactions generated from trading in goods and services.

The asset market approach views currencies as asset prices traded in an efficient financial market. Consequently, currencies are increasingly demonstrating a strong correlation with other markets, particularly equities.

Like the stock exchange, money can be made (or lost) on trading by investors and speculators in the foreign exchange market. Currencies can be traded at spot and foreign exchange options markets. The spot market represents current exchange rates, whereas options are derivatives of exchange rates.

**Manipulation of exchange rates**

A country may gain an advantage in international trade if it controls the market for its currency to keep its value low, typically by the national central bank engaging in open market operations in the foreign exchange market. In the early twenty-first century it was widely asserted that the People’s Republic of China had been doing this over a long period of time.

Other nations, including Iceland, Japan, Brazil, and so on have had a policy of maintaining a low value of their currencies in the hope of reducing the cost of exports and thus bolstering their economies. A lower exchange rate lowers the price of a country’s goods for consumers in other countries, but raises the price of imported goods and services for consumers in the low value currency country.

In general, exporters of goods and services will prefer a lower value for their currencies, while importers will prefer a higher value.

**Questions for self-control**

1. What is the meaning of the term “currency”?  
2. Who is the participant in the foreign exchange market? For what purpose do different categories of its participants enter the foreign exchange market?  
3. How can you classify foreign exchange transactions?  
4. What is the essence of the international monetary system? What are the elements that make it up?  
5. What stages of development has the international monetary system gone through?  
6. Compare international monetary systems. What are their differences? What are their advantages and disadvantages?
7. What is the special role of the dollar at the present stage of development of the international monetary system?
8. What determined the need to create a European monetary system?
9. What is the exchange rate and what is its significance for the country’s economy?
10. What determines the slope of the supply and demand curves for the currency?
11. What factors affect the value of the exchange rate and how?
12. What are the measures of government influence on the value of the exchange rate?
13. What is the meaning of the theory of purchasing power parity of currencies?
14. What is meant by the foreign exchange market? What is its structure?
15. What is currency quotation? What types of quotes are there?
16. What is a cross-rate?
17. What are the rules for calculating the cross rate?
18. Describe the spot and forward market.
19. What determines the value of the spot and forward rates?
20. How are futures contracts different from forward contracts?
21. What transactions in the foreign exchange market are called swap transactions?
22. What is a currency option?
23. What is the difference between arbitrageurs, hedgers and speculators operating in the foreign exchange market?
24. What is currency convertibility?
25. What are the degrees of convertibility of currencies?
26. What currencies are freely convertible?
27. What currency is the modern Russian ruble in terms of convertibility?
28. What forms and types of international credit exist?
4. EXCHANGE RATE REGIME

An exchange rate regime is the way a monetary authority of a country or currency union manages the currency in relation to other currencies and the foreign exchange market. It is closely related to monetary policy and the two are generally dependent on many of the same factors, such as economic scale and openness, inflation rate, elasticity of the labor market, financial market development, capital mobility etc.

There are two major regime types:

1) floating (or flexible) exchange rate regime exist where exchange rates are determined solely by market forces and often manipulated by open-market operations. Countries do have the ability to influence their floating currency from activities such as buying/selling currency reserves, changing interest rates, and through foreign trade agreements$.

2) fixed (or pegged) exchange rate regimes, exist when a country sets the value of its home currency directly proportional to the value of another currency or commodity. For years many currencies were fixed (or pegged) to gold. If the value of gold rose, the value of the currency fixed to gold would also rise. Today, many currencies are fixed (pegged) to floating currencies from major nations. Many countries fixed their currency value to the U.S. Dollar, the Euro, or the British Pound.

There are also intermediate exchange rate regimes that combine elements of the other regimes.

This classification of exchange rate regime is based on the classification method carried out by GGOW (Ghos, Guide, Ostry and Wolf, 1995, 1997), which combined the IMF de jure classification with the actual exchange behavior so as to differentiate between official and actual policies. The GGOW classification method is also called Trichotomy Method.

Fixed versus Floating

There are many factors a country should consider before deciding on a fixed or floating currency, with pros and cons to both choices.

If a country chooses to fix its currency to the U.S. Dollar they achieve exchange rate stability. This means anytime the trade with the U.S. there will always be certainty on how their currency will be worth in terms of U.S. Dollars. Hong Kong pegged their currency to the U.S. dollar at a rate of approximately 8 to 1. Every 1 U.S. dollar will always be worth about 8 Hong Kong dollars unless they change their regime. Businesses love this certainty and pegging your currency can often lead to lots
of foreign direct investment (FDI). Unfortunately, when a country decides to fix their currency they give up monetary autonomy. They are not able to set their own exchange rates and the strength/weakness of their currency is fully dependant on the currency they fixed itself to.

If a country chooses to be free-floating, like the U.S. dollar, they are monetarily independent however they lose the exchange rate stability that fixed currencies have. Notice you can not achieve a that is monetarily independent yet also has an exchange rate stability. This inability to have both is part of a concept known as the incompatible trinity. When deciding upon a currency regime countries can achieve two out of three things. Full financial integration, exchange rate stability, or monetary independence. A country can never have a currency that achieves all three.

A floating (or flexible) exchange rate regime is one in which a country’s exchange rate fluctuates in a wider range and the country’s monetary authority makes no attempt to fix it against any base currency. A movement in the exchange is either an appreciation or depreciation.

In macroeconomics and economic policy, a floating exchange rate (also known as a fluctuating or flexible exchange rate) is a type of exchange rate regime in which a currency’s value is allowed to fluctuate in response to foreign exchange market events. A currency that uses a floating exchange rate is known as a floating currency, in contrast to a fixed currency, the value of which is instead specified in terms of material goods, another currency, or a set of currencies (the idea of the last being to reduce currency fluctuations).

In the modern world, most of the world’s currencies are floating, and include the most widely traded currencies: the United States dollar, the euro, the Swiss franc, the Indian rupee, the pound sterling, the Japanese yen, and the Australian dollar. However, even with floating currencies, central banks often participate in markets to attempt to influence the value of floating exchange rates. The Canadian dollar most closely resembles a pure floating currency because the Canadian national bank has not interfered with its price since it officially stopped doing so during 1998. The US dollar is a close second, with very little change of its foreign reserves. By contrast, Japan and the UK intervene to a greater extent, and India has medium-range intervention by its national bank, the Reserve Bank of India [citation needed].

From 1946 to the early 1970s, the Bretton Woods system made fixed currencies the norm; however, during 1971, the US government decided to discontinue maintaining the dollar exchange at 1/35 of an ounce of gold and so its currency was no longer fixed. After the end of the Smithsonian
Agreement in 1973, most of the world’s currencies followed suit. However, some countries, such as most of the Arab states of the Persian Gulf region, fixed their currency to the value of another currency, which has been associated more recently with slower rates of growth. When a currency floats, quantities other than the exchange rate itself are used to administer monetary policy (see open-market operations).

**Economic rationale**

Some economists believe that in most circumstances, floating exchange rates are preferable to fixed exchange rates. As floating exchange rates adjust automatically, they enable a country to dampen the effect of shocks and foreign business cycles and to preempt the possibility of having a balance of payments crisis. However, they also engender unpredictability as the result of their variability, which can render businesses’ planning risky since the future exchange rates during their planning periods are uncertain.

However, in certain situations, fixed exchange rates may be preferable for their greater stability and certainty. That may not necessarily be true, considering the results of countries that attempt to keep the prices of their currency “strong” or “high” relative to others, such as the UK, or the Southeast Asia countries before the Asian currency crisis.

The debate of choosing between fixed and floating exchange rate methods is formalized by the Mundell-Fleming model, which argues that an economy (or the government) cannot simultaneously maintain a fixed exchange rate, free capital movement, and an independent monetary policy. It must choose any two for control and leave the other to market forces.

The primary argument for a floating exchange rate is that it allows monetary policies to be useful for other purposes. Using fixed rates, monetary policy is committed to the single goal of maintaining the exchange rate at its announced level. However, the exchange rate is only one of the many macroeconomic variables that monetary policy can influence. A system of floating exchange rates leaves monetary policymakers free to pursue other goals, such as stabilizing employment or prices.

During an extreme appreciation or depreciation of currency, a central bank will normally intervene to stabilize the currency. Thus, the exchange rate methods of floating currencies may more technically be known as managed float. A national bank might, for instance, allow a currency price to float freely between an upper and lower bound, a price “ceiling”
and “floor”. Management by a national bank may take the form of buying or selling large lots in order to provide price support or resistance or, in the case of some national currencies, there may be legal penalties for trading outside these bounds.

Aversion to floating
A free floating exchange rate increases foreign exchange volatility. Some economists believe that this could cause serious problems, especially in developing economies. Those economies have a financial sector with one or more of following conditions: high liability dollarization, financial fragility, strong balance sheet effects.

When liabilities are denominated in foreign currencies while assets are in the local currency, unexpected depreciations of the exchange rate deteriorate bank and corporate balance sheets and threaten the stability of the domestic financial system.

Therefore, developing countries seem to have greater aversion to floating, as they have much smaller variations of the nominal exchange rate but experience greater shocks and interest rate and reserve changes. This is the consequence of frequent free floating countries’ reaction to exchange rate changes with monetary policy and/or intervention in the foreign exchange market.

Free float (Floating exchange rate)
Under a free float, also known as clean float, a currency’s value is allowed to fluctuate in response to foreign-exchange market mechanisms without government intervention.

Managed float (or dirty float)
Under a managed float, also known as dirty float, a government may intervene in the market exchange rate in a variety of ways and degrees, in an attempt to make the exchange rate move in a direction conducive to the economic development of the country, especially during an extreme appreciation or depreciation.

A monetary authority may, for example, allow the exchange rate to float freely between an upper and lower bound, a price “ceiling” and “floor”.

Intermediate rate regime
Exchange rate regime of the Bank of Russia
Russia is using a floating exchange rate regime, which implies that the exchange rate of the ruble is not fixed and that there are no
pre-established targets for its exchange rate or the pace of its movements. The dynamics of the exchange rate of the ruble are determined by the ratio of the demand for and supply of foreign currency in the foreign exchange market. A flexible exchange rate helps Russia to adjust to changing external conditions, smoothing out the impact of external factors on the economy.

In normal conditions, the Bank of Russia does not conduct any foreign exchange interventions to influence the exchange rate of the ruble. That said, the Bank of Russia is keeping a close eye on the situation in the foreign exchange market and may carry out foreign currency operations in order to support financial stability.

*Floating exchange rate regime*

Russia is currently using a floating exchange rate regime, which means that foreign exchange rates against the ruble are determined by market forces, that is, the ratio of the demand for and supply of foreign currency in the foreign exchange market. Any factors affecting this ratio may cause the exchange rate to fluctuate. Specifically, exchange rate dynamics may be affected by movements of import and export prices, inflation and interest rates in Russia and abroad, the pace of economic growth, investor sentiment and expectations in Russia and abroad, as well as changes in the monetary policy of the central banks of Russia or other countries. (Data on fluctuations of the ruble exchange rate and factors causing these changes are published in the quarterly Monetary Policy Report).

Thus, the exchange rate of the ruble is not determined by the government or the central bank, it is not fixed, and there are no pre-established targets for the exchange rate or the pace of its movements. In normal conditions, the Bank of Russia does not conduct any foreign exchange interventions to influence the exchange rate of the ruble. This is what distinguishes a floating exchange rate regime from the multiple varieties of managed exchange rate regimes.

Pursuant to Article 34.1 of the Federal Law ‘On the Central Bank of the Russian Federation (Bank of Russia)’, the main goal of the Bank of Russia’s monetary policy is to protect the ruble and ensure its strength through maintaining price stability. The stability of the national currency does not imply setting a fixed exchange rate against other currencies, but rather preserving the purchasing power of money as a result of sustainably low inflation. When inflation remains low, the volume of goods and services that may be purchased for the same amount in rubles
changes only slightly over a long period of time. This supports the confidence of both households and businesses in the national currency and creates favourable conditions for the growth of the Russian economy.

A floating exchange rate is a critical component of an inflation targeting regime, where the primary goal of the central bank is to ensure price stability. The Bank of Russia implemented the floating exchange rate regime in November 2014. This switch was preceded by a long period during which the Bank of Russia had been gradually increasing the flexibility of the exchange rate, consistently reducing its presence in the domestic foreign exchange market. In addition, the switch to the floating exchange rate regime was progressive, which helped to moderate the process of market participants’ adjustment to exchange rate fluctuations amid the higher flexibility of the exchange rate.

Rationale for the switch to the floating exchange rate

A floating exchange rate functions as a ‘built-in stabiliser’ of the economy, which is its key advantage over a managed exchange rate. It helps the economy to adjust to changing external conditions, smoothing out the impact of external factors.

For instance, when oil prices grow, the ruble strengthens, which reduces risks of economic overheating, while declining oil prices entail depreciation of the ruble, which supports domestic manufacturers owing to increasing exports and the promotion of import substitution.

Another example of the effect of a floating exchange rate as a ‘built-in stabiliser’ is its impact on transborder capital flows. When the exchange rate is fixed or managed, alteration of interest rates by foreign states and, consequently, changes in the difference between internal and external interest rates may result in an increase in the inflow or outflow of speculative capital. Under a floating exchange rate regime, a rise in the demand for or supply of foreign currency from market participants as a result of changes in the difference between internal and external interest rates entails respective movements of the exchange rate, thus making speculative transactions unprofitable.

A fixed or managed exchange rate regime increases the dependency of the economy on external conditions. Therefore, it also makes monetary policy dependent on other countries’ policies and on the foreign economic environment. Under a managed exchange rate regime, the central bank must carry out operations in order to impact the exchange rate of the national currency when external conditions alter. In turn, these operations may also influence other economic indicators, including inflation, and moreover, in an undesirable manner.
A floating exchange rate enables the Bank of Russia to implement independent monetary policy aimed at addressing internal issues, and first of all at decreasing inflation.

Today, floating exchange rate regimes are applied by the majority of developed economies.

**Role of the Bank of Russia in the foreign exchange market**

The switch to the floating exchange rate regime means that the Bank of Russia abstains from regular foreign exchange interventions to influence the exchange rate of the ruble. The central bank’s policy under the floating exchange rate regime implies that in normal conditions the regulator does not intervene in market processes, letting the ruble exchange rate function as a ‘built-in stabiliser’.

Simultaneously, the Bank of Russia continues to keep a close eye on the situation in the foreign exchange market and may conduct foreign currency transactions (including on a reverse basis) so as to maintain financial stability.

The Bank of Russia sees as a threat to financial stability such movements of the exchange rate which may induce persistent devaluation expectations, increase demand for foreign currency cash and the dollarisation of deposits, and materially deteriorate the financial sustainability of credit institutions and businesses.

The Bank of Russia may carry out operations in the foreign exchange market to replenish international reserves. With a significant amount of international reserves, the Bank of Russia will be able to carry out operations aimed at supporting financial stability and the ongoing servicing of external debt over several years, even if the situation in the economy becomes challenging.

Operations for replenishing international reserves should be conducted in small amounts to avoid any influence on the exchange rate of the ruble. In making its decisions on purchasing foreign currency, the Bank of Russia takes into account movements of the exchange rate, the situation in the Russian economy, and the country’s balance of payments.

**Communication of information on exchange rate policy**

Information on the Bank of Russia’s exchange rate policy and factors influencing the exchange rate of the ruble is provided in the Monetary Policy Reports, the Monetary Policy Guidelines, and the Bank of Russia Annual Report. In addition, any decision on exchange rate policy is followed by a press release.
**Spot Exchange Rate**

A spot exchange rate is the current price level in the market to directly exchange one currency for another, for delivery on the earliest possible value date. Cash delivery for spot currency transactions is usually the standard settlement date of two business days after the transaction date.

**Understanding the Spot Exchange Rate**

The spot exchange rate is best thought of as how much you would have to pay in one currency to buy another at this moment in time. The spot exchange rate is usually decided through the global foreign exchange market where currency traders, institution and countries clear transactions and trades. The forex market is the largest and most liquid market in the world, with trillions of dollars changing hands daily. The most actively traded currencies are the U.S. dollar, the euro – which is used in many continental European countries including Germany, France, and Italy – the British pound, the Japanese yen and the Canadian dollar.

Trading takes place electronically around the world between large, multinational banks. Other active market participants include corporations, mutual funds, hedge funds, insurance companies and government entities. Transactions are for a wide range of purposes, including import and export payments, short- and long-term investments, loans and speculation.

Some currencies, especially in developing economies, are controlled by the government that sets the spot exchange rate. For instance, the central government of China sets a currency peg that keeps the Yuan within a tight trading range against the U.S. dollar.

**Spot Exchange Rate Transactions**

For most spot foreign exchange transactions, the settlement date is two business days after the transaction date. The most common exception to the rule is the U.S. dollar vs. the Canadian dollar, which settles on the next business day. Weekends and holidays mean that two business days is often far more than two calendar days, especially during the Christmas and Easter holiday season.

On the transaction date, the two parties involved in the transaction agree on the price, which is the number of units of currency A that will be exchanged for currency B. The parties also agree on the value of the transaction in both currencies and the settlement date. If both currencies are to be delivered, the parties also exchange bank information. Speculators often buy and sell multiple times for the same settlement date, in which case the transactions are netted and only the gain or loss is settled.
The Spot Market

The foreign exchange spot market can be very volatile. In the short term, rates are often driven by news, speculation and technical trading. In the long term, rates are generally driven by a combination of national economic fundamentals and interest rate differentials. Central banks sometimes intervene to smooth the market, either by buying or selling the local currency or by adjusting interest rates. Countries with large foreign currency reserves are much better positioned to influence their domestic currency’s spot exchange rate.

How to Execute a Spot Exchange

There are a number of different ways in which traders can execute a spot exchange, especially with the advent of online trading systems. The exchange can be made directly between two parties, eliminating the need for a third party. Electronic broking systems may also be used, where dealers can make their trades through an automated order matching system. Traders can also use electronic trading systems through a single or multi-bank dealing system. Finally, trades can be made through a voice broker, or over the phone with a foreign exchange broker.

International Currency Markets

What Are the International Currency Markets

The international currency market is a market in which participants from around the world buy and sell different currencies. Participants include banks, corporations, central banks, investment management firms, hedge funds, retail forex brokers, and investors. The international currency market is important because it helps to facilitate global transactions, including loans, investments, corporate acquisitions, and global trade.

How the International Currency Markets Work

The international currency market is the largest financial market in the world, with an average daily trading volume of $5 trillion. In this market, transactions do not occur on a single exchange, but in a global computer network of large banks and brokers from around the world.

The currency market, or foreign exchange market (“forex”), was created to facilitate the exchange of currency that is necessary as the result of foreign trade. For example, if a Canadian company sells a product to a U.S. firm, it’ll want to be paid in Canadian dollars. The U.S. firm would need to facilitate a foreign exchange conversion through its bank to pay the Canadian company. The U.S. firm’s bank account would be debited
in U.S dollars. The U.S. bank would transfer the funds to the Canadian company’s bank. The funds would be converted to Canadian dollars at a preset exchange rate and credited to the Canadian company’s account.

The global currency market helps to facilitate foreign trade because it allows companies to sell their goods globally and get paid in their local currency. Companies need to be paid in their local currency since their expenses, such as payroll, are in their local currency.

The forex market differs from the stock market in that it does not involve a clearinghouse. Transactions occur directly between parties without an intermediary to ensure that each party complies with its obligations. Currencies do not come with a single price but are priced in terms of other currencies.

The Major Currency Pairs
Below are the major currency pairs that are most widely exchanged for each other.

- EUR/USD: the euro of the Eurozone versus the U.S. dollar
- USD/JPY: the U.S. dollar versus the Japanese yen
- GBP/USD: the Great British pound versus the U.S. dollar
- USD/CHF: the U.S. dollar versus the Swiss franc of Switzerland
- USD/CAD: the U.S. dollar versus the Canadian dollar
- AUD/USD: the Australian dollar versus the U.S. dollar

The U.S. dollar is considered the world’s reserve currency since the U.S. has a stable economy and financial system. Many products, commodities, and investments are transacted in U.S. dollars, which is why it’s involved most of the major transactions and currency exchanges. Countries that don’t have a stable market or currency exchange rate might opt to trade in dollars to attract investment and facilitate trade.

However, there are many other currency pairs that are traded globally. Although China has the yuan and the renminbi as their currencies, most of the transactions involving U.S. trade with China are facilitated in U.S. dollars.

Safe-Haven Currencies
Certain currencies have taken on a specific identity or role in the global markets. For example, Switzerland has long been considered a safe place to store money in times of political and economic upheaval. During troubling times, forex conversions from the other global currencies into Swiss francs tends to increase significantly.
Japan is also considered a safe-haven for investment flows since Japan is considered a stable economy. In times of economic recessions, many investors exchange their investments denominated in dollars, euros, and pounds for Japanese government bonds (JGBs), which are guaranteed by the government of Japan. As a result, the yen tends to appreciate against other major currencies during recessions. For example, U.S. investors might sell their dollar-denominated mutual funds or investments for yen-denominated Japanese government bonds, and in doing so, cause the yen to appreciate against the dollar due to the forex conversion.

**International Currency Market Players**

Although there are many participants involved in the global currency markets, below are some of the major players that are involved in the forex markets.

**Corporations**

Sometimes corporations enter the forex market in order to hedge their international money transfers and foreign profits. A U.S. company with extensive operations in Mexico, for example, may enter into a forward contract, which merely locks in the exchange rate between the dollar and the Mexican peso. So, when it comes time to bring those Mexican profits home, the profits earned in pesos would not be subject to unexpected exchange rate fluctuations. Instead, the pesos would be converted to dollars at the preset forward exchange rate. Companies use forwards as part of an overall risk-management strategy to help prevent currency exchange rates from impacting earnings or profits.

**Governments and Central Banks**

Governments may seek to influence the value of their currencies – called devaluation – to help increase their exports or foreign sales. A country’s central bank, which manages a country’s money supply, may enter the market to sell the country’s currency, helping to push the value down. When the exchange rate declines versus the other major currencies, the country benefits from having cheaper exports solely due to the exchange rate.

For example, if the U.S. and British pound exchange rate was $2, and an investor wanted to buy a home in Britain that costs 200,000 pounds, it would cost the investor $400,000 (2 × 200,000 pounds). If Britain lowered their exchange rate to $1.50, the U.S. investor could now buy the same property for $300,000 (1.50 × 200,000 pounds).

As a result, the devaluing of the British currency would likely attract enormous buying interest from foreign investors boosting demand for
British goods, real estate, and bolstering the British economy. Sometimes countries that engage in currency exchange rate devaluations can be labeled a “currency manipulator”.

The foreign exchange market is where currencies are traded. Currencies are important to most people around the world, whether they realize it or not, because currencies need to be exchanged in order to conduct foreign trade and business. If you are living in the U.S. and want to buy cheese from France, either you or the company that you buy the cheese from has to pay the French for the cheese in euros (EUR). This means that the U.S. importer would have to exchange the equivalent value of U.S. dollars (USD) into euros. The same goes for traveling. A French tourist in Egypt can’t pay in euros to see the pyramids because it’s not the locally accepted currency. As such, the tourist has to exchange the euros for the local currency, in this case the Egyptian pound, at the current exchange rate.

One unique aspect of this international market is that there is no central marketplace for foreign exchange. Rather, currency trading is conducted electronically over-the-counter (OTC), which means that all transactions occur via computer networks between traders around the world, rather than on one centralized exchange. The market is open 24 hours a day, five and a half days a week, and currencies are traded worldwide in the major financial centers of London, New York, Tokyo, Zurich, Frankfurt, Hong Kong, Singapore, Paris and Sydney – across almost every time zone. This means that when the trading day in the U.S. ends, the forex market begins anew in Tokyo and Hong Kong. As such, the forex market can be extremely active any time of the day, with price quotes changing constantly.

Unlike stock markets, which can trace their roots back centuries, the forex market as we understand it today is a truly new market. Of course, in its most basic sense – that of people converting one currency to another for financial advantage – forex has been around since nations began minting currencies. But the modern forex markets are a modern invention. After the accord at Bretton Woods in 1971, more major currencies were allowed to float freely against one another. The values of individual currencies vary, which has given rise to the need for foreign exchange services and trading.

Commercial and investment banks conduct most of the trading in the forex markets on behalf of their clients, but there are also speculative opportunities for trading one currency against another for professional and individual investors.
Spot Market and the Forwards & Futures Markets

There are actually three ways that institutions, corporations and individuals trade forex: the spot market, the forwards market, and the futures market. Forex trading in the spot market has always been the largest market because it is the "underlying" real asset that the forwards and futures markets are based on. In the past, the futures market was the most popular venue for traders because it was available to individual investors for a longer period of time. However, with the advent of electronic trading and numerous forex brokers, the spot market has witnessed a huge surge in activity and now surpasses the futures market as the preferred trading market for individual investors and speculators. When people refer to the forex market, they usually are referring to the spot market. The forwards and futures markets tend to be more popular with companies that need to hedge their foreign exchange risks out to a specific date in the future.

More specifically, the spot market is where currencies are bought and sold according to the current price. That price, determined by supply and demand, is a reflection of many things, including current interest rates, economic performance, sentiment towards ongoing political situations (both locally and internationally), as well as the perception of the future performance of one currency against another. When a deal is finalized, this is known as a “spot deal”. It is a bilateral transaction by which one party delivers an agreed-upon currency amount to the counter party and receives a specified amount of another currency at the agreed-upon exchange rate value. After a position is closed, the settlement is in cash. Although the spot market is commonly known as one that deals with transactions in the present (rather than the future), these trades actually take two days for settlement.

Unlike the spot market, the forwards and futures markets do not trade actual currencies. Instead they deal in contracts that represent claims to a certain currency type, a specific price per unit and a future date for settlement.

In the forwards market, contracts are bought and sold OTC between two parties, who determine the terms of the agreement between themselves.

In the futures market, futures contracts are bought and sold based upon a standard size and settlement date on public commodities markets, such as the Chicago Mercantile Exchange. In the U.S., the National Futures Association regulates the futures market. Futures contracts have specific details, including the number of units being traded, delivery and
settlement dates, and minimum price increments that cannot be customized. The exchange acts as a counterpart to the trader, providing clearance and settlement.

Both types of contracts are binding and are typically settled for cash at the exchange in question upon expiry, although contracts can also be bought and sold before they expire. The forwards and futures markets can offer protection against risk when trading currencies. Usually, big international corporations use these markets in order to hedge against future exchange rate fluctuations, but speculators take part in these markets as well.

Note that you’ll often see the terms: FX, forex, foreign-exchange market, and currency market. These terms are synonymous and all refer to the forex market.

Companies doing business in foreign countries are at risk due to fluctuations in currency values when they buy or sell goods and services outside of their domestic market. Foreign exchange markets provide a way to hedge currency risk by fixing a rate at which the transaction will be completed.

To accomplish this, a trader can buy or sell currencies in the forward or swap markets in advance, which locks in an exchange rate. For example, imagine that a company plans to sell U.S.-made blenders in Europe when the exchange rate between the euro and the dollar (EUR/USD) is €1 to $1 at parity.

The blender costs $100 to manufacture, and the U.S. firm plans to sell it for €150 – which is competitive with other blenders that were made in Europe. If this plan is successful, the company will make $50 in profit because the EUR/USD exchange rate is even. Unfortunately, the USD begins to rise in value versus the euro until the EUR/USD exchange rate is 0.80, which means it now costs $0.80 to buy €1.00.

The problem the company faces is that while it still costs $100 to make the blender, the company can only sell the product at the competitive price of €150, which when translated back into dollars is only $120 (€150 X 0.80 = $120). A stronger dollar resulted in a much smaller profit than expected.

The blender company could have reduced this risk by shorting the euro and buying the USD when they were at parity. That way, if the dollar rose in value, the profits from the trade would offset the reduced profit from the sale of blenders. If the USD fell in value, the more favorable exchange rate will increase the profit from the sale of blenders, which offsets the losses in the trade.
Hedging of this kind can be done in the currency futures market. The advantage for the trader is that futures contracts are standardized and cleared by a central authority. However, currency futures may be less liquid than the forward markets, which are decentralized and exist within the interbank system throughout the world.

Factors like interest rates, trade flows, tourism, economic strength, and geopolitical risk affect supply and demand for currencies, which creates daily volatility in the forex markets. An opportunity exists to profit from changes that may increase or reduce one currency’s value compared to another. A forecast that one currency will weaken is essentially the same as assuming that the other currency in the pair will strengthen because currencies are traded as pairs.

Imagine a trader who expects interest rates to rise in the U.S. compared to Australia while the exchange rate between the two currencies (AUD/USD) is 0.71 (it takes $0.71 USD to buy $1.00 AUD). The trader believes higher interest rates in the U.S. will increase demand for USD, and therefore the AUD/USD exchange rate will fall because it will require fewer, stronger USD to buy an AUD.

Assume that the trader is correct and interest rates rise, which decreases the AUD/USD exchange rate to 0.50. This means that it requires $0.50 USD to buy $1.00 AUD. If the investor had shorted the AUD and went long the USD, he or she would have profited from the change in value.

There are two distinct features to currencies as an asset class:
- You can earn the interest rate differential between two currencies.
- You can profit from changes in the exchange rate.

An investor can profit from the difference between two interest rates in two different economies by buying the currency with the higher interest rate and shorting the currency with the lower interest rate. Prior to the 2008 financial crisis, it was very common to short the Japanese yen (JPY) and buy British pounds (GBP) because the interest rate differential was very large. This strategy is sometimes referred to as a “carry trade”.

Currency trading was very difficult for individual investors prior to the internet. Most currency traders were large multinational corporations, hedge funds or high-net-worth individuals because forex trading required a lot of capital. With help from the internet, a retail market aimed at individual traders has emerged, providing easy access to the foreign exchange markets, either through the banks themselves or brokers making a secondary market. Most online brokers or dealers offer very high leverage to individual traders who can control a large trade with a small account balance.
Trading currencies can be risky and complex. The interbank market has varying degrees of regulation, and forex instruments are not standardized. In some parts of the world, forex trading is almost completely unregulated.

The interbank market is made up of banks trading with each other around the world. The banks themselves have to determine and accept sovereign risk and credit risk, and they have established internal processes to keep themselves as safe as possible. Regulations like this are industry-imposed for the protection of each participating bank.

Since the market is made by each of the participating banks providing offers and bids for a particular currency, the market pricing mechanism is based on supply and demand. Because there are such large trade flows within the system, it is difficult for rogue traders to influence the price of a currency. This system helps create transparency in the market for investors with access to interbank dealing.

Most small retail traders trade with relatively small and semi-unregulated forex brokers/dealers, which can (and sometimes do) re-quote prices and even trade against their own customers. Depending on where the dealer exists, there may be some government and industry regulation, but those safeguards are inconsistent around the globe.

Most retail investors should spend time investigating a forex dealer to find out whether it is regulated in the U.S. or the U.K. (dealers in the U.S. and U.K. have more oversight) or in a country with lax rules and oversight. It is also a good idea to find out what kind of account protections are available in case of a market crisis, or if a dealer becomes insolvent.

Pro: The forex markets are the largest in terms of daily trading volume in the world and therefore offer the most liquidity. This makes it easy to enter and exit a position in any of the major currencies within a fraction of a second for a small spread in most market conditions.

Challenge: Banks, brokers, and dealers in the forex markets allow a high amount of leverage, which means that traders can control large positions with relatively little money of their own. Leverage in the range of 100:1 is a high ratio but not uncommon in forex. A trader must understand the use of leverage and the risks that leverage introduces in an account. Extreme amounts of leverage have led to many dealers becoming insolvent unexpectedly.

Pro: The forex market is traded 24 hours a day, five days a week – starting each day in Australia and ending in New York. The major centers are Sydney, Hong Kong, Singapore, Tokyo, Frankfurt, Paris, London, and New York.
Challenge: Trading currencies productively requires an understanding of economic fundamentals and indicators. A currency trader needs to have a big-picture understanding of the economies of the various countries and their inter-connectedness to grasp the fundamentals that drive currency values.

The Bottom Line
For traders – especially those with limited funds – day trading or swing trading in small amounts is easier in the foreign exchange market than other markets. For those with longer-term horizons and larger funds, long-term fundamentals-based trading or a carry trade can be profitable. A focus on understanding the macroeconomic fundamentals driving currency values and experience with technical analysis may help new foreign exchange traders to become more profitable.

Questions for self-control

1. What methods of entering foreign markets are used in international trade?
2. What are the advantages and disadvantages of going through intermediaries?
3. What types of services are provided by intermediary firms in international trade?
4. In what situations is it advisable to use the services of intermediaries?
5. What are the features of the choice of intermediary firms?
6. What types of intermediary firms exist in international practice?
7. What types of agreements govern the relationship of partners in intermediary relationships?
8. What is the peculiarity of the contract for the right to sell?
9. What is the difference between a commission agreement and a consignment agreement?
10. What is a monopoly clause in a mediation agreement?
11. What conditions of intermediary agreements protect the interests of the exporter, and which – of the intermediary?
5. FOREIGN EXCHANGE INTERVENTIONS

Unilateral or concerted action
In the absence of any formal agreements or general guidelines, the Eurosystem may decide, where necessary, to conduct foreign exchange interventions. The Eurosystem may conduct such interventions either on its own (i.e. unilaterally) or as part of a coordinated intervention involving other central banks (i.e. concerted action).

Centralised or decentralised
Interventions may be carried out either directly by the ECB (i.e. in a centralised manner) or by NCBs acting on behalf of the ECB on a “disclosed agency” basis (i.e. in a decentralised manner). Whether the intervention is conducted in a centralised or a decentralised manner is irrelevant from the point of view of the ultimate objective of the operation.

Any intervention relating to another EU currency is performed without prejudice to the ECB’s primary objective of maintaining price stability and is carried out by the Eurosystem in close cooperation with the relevant non-euro area NCB, particularly with regard to the financing of the intervention.

Exchange rate mechanism II
Background
Foreign exchange interventions may also take place within the framework of the exchange rate mechanism II (ERM II), which entered into force at the start of Stage Three of Economic and Monetary Union. ERM II is based mainly on two legal documents: a European Council resolution of 16 June 1997; and an agreement of 1 September 1998, as amended, between the ECB and the NCBs of the non-euro area countries.

Participants
Denmark has participated in ERM II since 4 January 1999, after participating in the original ERM. Bulgaria and Croatia joined on 13 July 2020.

Role of the ECOFIN Council
Foreign exchange interventions can also be conducted in the context of institutional exchange rate relations between the euro and the currencies
of countries outside the European Union (e.g. the US dollar and the Japanese yen). With regard to these currencies, Article 219 of the Treaty provides for two possible institutional arrangements:

– the ECOFIN Council can conclude formal agreements on an exchange rate system for the euro;
– the ECOFIN Council can formulate general guidelines for the Eurosystem’s exchange rate policy.

To date, neither of these two procedures has been implemented. The ECB would be involved in either case, either providing a recommendation to, or being consulted by, the ECOFIN Council. Both of these institutional procedures must, however, be without prejudice to the primary objective of maintaining price stability. The ECB’s capacity to carry out foreign exchange interventions is not restricted by its foreign reserve holdings. The ECB can also fund interventions by other means, such as foreign exchange swaps.

Conventions and Procedures for the Exchange Rate Mechanism II (ERM II)

The Exchange Rate Mechanism II (ERM II) was introduced at the start of Stage Three of EMU, on 1 January 1999. This mechanism links the currencies of non-euro area Member States to the euro. By helping to ensure that the non-euro area Member States participating in the mechanism orient their policies towards stability, ERM II fosters convergence and thereby helps them in their efforts to adopt the euro. Participation in the exchange rate mechanism is voluntary for all non-euro area Member States. However, as ERM II membership is one of the convergence criteria for the eventual adoption of the euro, new Member States are expected to join the mechanism at some stage. The operating procedures for ERM II have been laid down in an agreement between the European Central Bank (ECB) and the non-euro area national central banks (NCBs).

For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined, in principle supported by automatic unlimited intervention at the margins, with very short-term financing available. However, the ECB and the participating non-euro area NCBs could suspend automatic intervention if this were to conflict with their primary objective of maintaining price stability. Exchange rate policy cooperation may be further strengthened, for example by allowing closer exchange rate links between the euro and other currencies in ERM II where, and to the
extent that, these are appropriate in the light of progress towards convergence.

The following operating features of the mechanism are applied:
– for all the currencies of the non-euro area Member States participating in ERM II, the exchange rate for the bilateral central rate against the euro is quoted using the euro as the base currency. This means that for all currencies the exchange rate is expressed as the value of 1 euro using six significant digits. The same convention is applied for quoting the upper and lower intervention rates against the euro of the currencies of the non-euro area Member States participating in ERM II. The intervention rates are determined by adding or subtracting the agreed bandwidth, expressed as a percentage, to or from the bilateral central rates. The resulting rates are rounded to six significant digits;
– in order to reduce the settlement risk inherent in unlimited intervention at the margins, a payment after payment procedure is applied by both the ECB and the euro area NCBs involved in the intervention and may be applied by the non-euro area NCBs participating in ERM II;
– under normal circumstances, both the ECB and the euro area NCBs will only conduct ERM II interventions between 9 a.m. and 5 p.m. Central European Time. Also, both the ECB and the euro area NCBs will not, under normal circumstances, intervene on the so-called TARGET holidays (i.e. 1 January, Good Friday, Easter Monday, 1 May, 25 and 26 December). Euro area NCBs may, in addition, observe other national holidays, while non-euro area NCBs may follow their own separate national holiday calendars.

The New York Fed is authorized by the Federal Open Market Committee (FOMC) to intervene in the foreign exchange (FX) market by executing FX transactions for the System Open Market Account (SOMA), as directed by the FOMC, and, in its capacity as fiscal agent of the United States, for the Exchange Stabilization Fund (ESF), as directed by the U.S. Treasury. The New York Fed also provides FX transaction services to its official sector account holders, U.S. government agencies (as directed by the U.S. Treasury), and the Federal Reserve System.

The Federal Reserve and the U.S. Treasury may intervene in the FX market when required to counter disorderly market conditions. After the breakdown of the Bretton Woods system in 1971, the United States monetary authorities (the Federal Reserve and the U.S. Treasury) used FX intervention both to reduce excess exchange rate volatility and to signal the views of the U.S. that the exchange rate did not reflect fundamental economic conditions. However, since 1996, the U.S. has only intervened

Interventions, at the direction of the FOMC or Treasury, are executed by the New York Fed. When a decision is made to support the dollar’s value against another currency, the New York Fed’s Open Market Trading Desk (the Desk) buys dollars and sells that foreign currency; conversely, to reduce the value of the dollar, it sells dollars and buys the foreign currency.

In the context of an operation to support the dollar’s value against another currency, the foreign currencies that are used to intervene have historically come equally from foreign exchange reserves held in the SOMA portfolio and the ESF. These holdings currently are in euros and Japanese yen. Interventions have historically been coordinated with other central banks, especially those that issue the currency or currencies involved in the intervention.

Separate from interventions, the Desk also provides FX transaction services to three primary sets of customers: the United States government and its agencies (as fiscal agent), foreign central banks and monetary authorities that hold accounts with the New York Fed, and the Federal Reserve System. FX transactions for the United States government and its agencies typically facilitate foreign-currency-denominated payments. These transactions typically make up the majority of the Desk’s FX trading volume. Foreign central banks that hold accounts at the New York Fed also regularly request FX transactions. Occasionally, the Desk also facilitates certain foreign-currency-denominated payments for the Board of Governors or other Federal Reserve Banks.

The Federal Reserve Act authorizes open market transactions, including foreign exchange transactions. The FOMC has authorized and directed the New York Fed to execute standalone spot and forward foreign exchange transactions in the resultant foreign currencies, to hold balances in those currencies, and to invest such foreign currency holdings, while maintaining sufficient liquidity to support foreign exchange interventions, as directed by the U.S. Treasury. The New York Fed conducts such operations pursuant to direction from the Federal Reserve’s Federal Open Market Committee (FOMC).

SOMA and ESF foreign currency reserves are currently held in euros and Japanese yen and are passively managed. These assets are invested, as directed, in various instruments that have high degrees of liquidity and safety to achieve the policy directives of the Federal Reserve and the U.S.
Treasury. The SOMA and the ESF foreign currency reserves are managed so that their risk and return characteristics match as closely as possible. To the extent practical, investments are split proportionately between the SOMA and ESF holdings.

Portfolio Management Goals
Liquidity is the primary investment objective of the foreign reserves portfolio. As such, foreign currency reserves are invested to ensure that adequate liquidity is maintained to meet potential needs. Maintaining a high degree of safety is also essential, but is a secondary objective for the purposes of portfolio management. Lastly, efforts to improve portfolio returns are considered only after the liquidity and safety objectives have been met.

Management Style
The foreign reserves portfolios are passively managed against an asset allocation target, which is determined based on the portfolio’s broader goals of maximizing returns subject to the liquidity and safety objectives. To that end, the manager of the SOMA and the ESF foreign reserves portfolios consults regularly with the FOMC and the U.S. Treasury regarding the disposition of investments and the status of the reserves portfolios.

Reserve Assets
The SOMA and ESF portfolios hold assets denominated in euros and Japanese yen. A significant portion of the U.S. monetary authorities’ foreign currency reserves is invested on an outright basis in government-backed securities. Foreign currency reserves may also be held on deposit at the Bank for International Settlements and at foreign central banks, such as the Deutsche Bundesbank, the Banque de France, and the Bank of Japan. Transactions are conducted with official institutions and eligible private-sector counterparties.

Breakdown of Foreign Reserve Assets Held
Carrying Value in Millions of U.S. Dollars, as of September 30, 2020

Open market operation
An open market operation (OMO) is an activity by a central bank to give (or take) liquidity in its currency to (or from) a bank or a group of banks. The central bank can either buy or sell government bonds in the open market (this is where the name was historically derived from)
or, in what is now mostly the preferred solution, enter into a repo or secured lending transaction with a commercial bank: the central bank gives the money as a deposit for a defined period and synchronously takes an eligible asset as collateral.

Central banks usually use OMO as the primary means of implementing monetary policy. The usual aim of open market operations is – aside from supplying commercial banks with liquidity and sometimes taking surplus liquidity from commercial banks – to manipulate the short-term interest rate and the supply of base money in an economy, and thus indirectly control the total money supply, in effect expanding money or contracting the money supply. This involves meeting the demand of base money at the target interest rate by buying and selling government securities, or other financial instruments. Monetary targets, such as inflation, interest rates, or exchange rates, are used to guide this implementation.

In the post-crisis economy, conventional short-term Open Market Operations have been superseded by major central banks by quantitative easing (QE) programmes. QE are technically similar open-market operations, but entail a pre-commitment of the central bank to conduct purchases to a pre-defined large volume and for a pre-defined period of time. Under QE, central banks typically purchase riskier and longer-term securities such as long maturity sovereign bonds and even corporate bonds.

Process of open market operations

The central bank maintains loro accounts for a group of commercial banks, the so-called direct payment banks. A balance on such a loro account (it is a nostro account in the view of the commercial bank) represents central bank money in the regarded currency. Since central bank money currently exists mainly in the form of electronic records (electronic money) rather than in the form of paper or coins (physical money), open market operations can be conducted by simply increasing or decreasing (crediting or debiting) the amount of electronic money that a bank has in its reserve account at the central bank. This does not require the creation of new physical currency, unless a direct payment bank demands to exchange a part of its electronic money against banknotes or coins.

In most developed countries, central banks are not allowed to give loans without requiring suitable assets as collateral. Therefore, most central banks describe which assets are eligible for open market transactions. Technically, the central bank makes the loan and synchronously takes an equivalent amount of an eligible asset supplied by the borrowing commercial bank.
Theoretical relationship to interest rates

Classical economic theory postulates a distinctive relationship between the supply of central bank money and short-term interest rates: like for a commodity, a higher demand for central bank money would increase its price, the interest rate. When there is an increased demand for base money, the central bank must act if it wishes to maintain the short-term interest rate. It does this by increasing the supply of base money: it goes to the open market to buy a financial asset, such as government bonds. To pay for these assets, new central bank money is generated in the seller’s loro account, increasing the total amount of base money in the economy. Conversely, if the central bank sells these assets in the open market, the base money is reduced.

Technically, the process works because the central bank has the authority to bring money in and out of existence. It is the only point in the whole system with the unlimited ability to produce money. Another organization may be able to influence the open market for a period of time, but the central bank will always be able to overpower their influence with an infinite supply of money.

Side note: Countries that have a free floating currency not pegged to any commodity or other currency have a similar capacity to produce an unlimited amount of net financial assets (bonds). Understandably, governments would like to utilize this capacity to meet other political ends like unemployment rate targeting, or relative size of various public services (military, education, health etc.), rather than any specific interest rate. Mostly, however the central bank is prevented by law or convention from giving way to such demands, being required to only generate central bank money in exchange for eligible assets (see above).

Possible targets

Under inflation targeting, open market operations target a specific short-term interest rate in the debt markets. This target is changed periodically to achieve and maintain an inflation rate within a target range. However, other variants of monetary policy also often target interest rates: the US Federal Reserve, the Bank of England and the European Central Bank use variations on interest rate targets to guide open market operations.

Besides interest rate targeting there are other possible targets of open markets operations. A second possible target is the contraction of the money supply, as was the case in the U.S. in the late 1970s through the early 1980s under Fed Chairman Paul Volcker.
Under a currency board open market operations would be used to achieve and maintain a fixed exchange rate with relation to some foreign currency.

Under a gold standard, notes would be convertible to gold, and so open market operations could be used to keep the value of a fiat currency constant relative to gold.

A central bank can also use a mixture of policy settings that change depending on circumstances. A central bank may peg its exchange rate (like a currency board) with different levels or forms of commitment. The looser the exchange rate peg, the more latitude the central bank has to target other variables (such as interest rates). It may instead target a basket of foreign currencies rather than a single currency. In some instances it is empowered to use additional means other than open market operations, such as changes in reserve requirements or capital controls, to achieve monetary outcomes.

**How open market operations are conducted**

In the United States, as of 2006 [citation needed], the Federal Reserve sets an interest rate target for the federal funds (overnight bank reserves) market. When the actual federal funds rate is higher than the target, the Federal Reserve Bank of New York will usually increase the money supply via a repurchase agreement (or repo), in which the Fed “lends” money to commercial banks. When the actual federal funds rate is less than the target, the Fed will usually decrease the money supply via a reverse repo, in which the banks purchase securities from the Fed. The Federal Reserve conducts open market operations with the objective of controlling short-term interest rates and the money supply. These operations fall into 2 categories: Dynamic open market operations are intended to change the level of reserves and the monetary base, and defensive open market operations are intended to offset movements in other factors that affect reserves and the monetary base, such as changes in Treasury deposits with the Fed or changes in float. In the United States, the Federal Reserve most commonly uses overnight repurchase agreements (repos) to temporarily create money, or reverse repos to temporarily destroy money, which offset temporary changes in the level of bank reserves. The Federal Reserve also makes outright purchases and sales of securities through the System Open Market Account (SOMA) with its manager over the Trading Desk at the New York Reserve Bank. The trade of securities in the SOMA changes the balance of bank reserves, which also affects short-term interest rates. The SOMA manager is responsible
for trades that result in a short-term interest rate near the target rate set by the Federal Open Market Committee (FOMC), or create money by the outright purchase of securities. More rarely will it permanently destroy money by the outright sale of securities. These trades are made with a group of about 22 banks and bond dealers called primary dealers.

Money is created or destroyed by changing the reserve account of the bank with the Federal Reserve. The Federal Reserve has conducted open market operations in this manner since the 1920s, through the Open Market Desk at the Federal Reserve Bank of New York, under the direction of the Federal Open Market Committee. OMOs also control inflation because when treasury bills are sold to commercial banks, it decreases the money supply.

The European Central Bank has similar mechanisms for their operations; it describes its methods as a four-tiered approach with different goals: beside its main goal of steering and smoothing Eurozone interest rates while managing the liquidity situation in the market the ECB also has the aim of signalling the stance of monetary policy with its operations.

Broadly speaking, the ECB controls liquidity in the banking system via refinancing operations, which are basically repurchase agreements, i.e. banks put up acceptable collateral with the ECB and receive a cash loan in return. These are the following main categories of refinancing operations that can be employed depending on the desired outcome:

Regular weekly main refinancing operations (MRO) with maturity of one week and, Monthly longer-term refinancing operations (LTRO) provide liquidity to the financial sector, while ad hoc “Fine-tuning operations” aim to smooth interest rates caused by liquidity fluctuations in the market through reverse or outright transactions, foreign exchange swaps, and the collection of fixed-term deposits “Structural operations” are used to adjust the central banks’ longer-term structural positions vis-à-vis the financial sector.

Refinancing operations are conducted via an auction mechanism. The ECB specifies the amount of liquidity it wishes to auction (called the allotted amount) and asks banks for expressions of interest. In a fixed rate tender the ECB also specifies the interest rate at which it is willing to lend money; alternatively, in a variable rate tender the interest rate is not specified and banks bid against each other (subject to a minimum bid rate specified by the ECB) to access the available liquidity.

MRO auctions are held on Mondays, with settlement (i.e., disbursal of the funds) occurring the following Wednesday. For example, at its
auction on 6 October 2008, the ECB made available 250 million in EUR on 8 October at a minimum rate of 4.25 %. It received 271 million in bids, and the allotted amount (250) was awarded at an average weighted rate of 4.99 %.

Since mid-October 2008, however, the ECB has been following a different procedure on a temporary basis, the fixed rate MRO with “full allotment”. In this case the ECB specifies the rate but not the amount of credit made available, and banks can request as much as they wish (subject as always to being able to provide sufficient collateral). This procedure was made necessary by the financial crisis of 2008 and is expected to end at some time in the future.

Though the ECB’s main refinancing operations (MRO) are from repo auctions with a (bi) weekly maturity and monthly maturation, Longer-Term Refinancing Operations (LTROs) are also issued, which traditionally mature after three months; since 2008, tenders are now offered for six months, 12 months and 36 months.

The Swiss National Bank (SNB) currently targets the three-month Swiss franc LIBOR rate. The primary way the SNB influences the three-month Swiss franc LIBOR rate is through open market operations, with the most important monetary policy instrument being repo transactions.

India’s Open Market Operation is much influenced by the fact that it is a developing country and that the capital flows are very different from those in developed countries. Thus India’s central bank, the Reserve Bank of India (RBI), has to make policies and use instruments accordingly. Prior to the 1991 financial reforms, RBI’s major source of funding and control over credit and interest rates was the cash reserve ratio (CRR) and the SLR (Statutory Liquidity Ratio). But after the reforms, the use of CRR as an effective tool was deemphasized and the use of open market operations increased. OMOs are more effective in adjusting [market liquidity].

The two type of OMOs used by RBI:
1) outright purchase (PEMO): Is outright buying or selling of government securities. (Permanent);
2) repurchase agreement (REPO): Is short term, and are subject to repurchase.

However, even after sidelining CRR as an instrument, there was still less liquidity and skewedness in the market. And thus, on the recommendations of the Narsimham Committee Report (1998), The RBI brought together a Liquidity Adjustment Facility (LAF).
It commenced in June, 2000, and it was set up to oversee liquidity on a daily basis and to monitor market interest rates. For the LAF, two rates are set by the RBI: repo rate and reverse repo rate. The repo rate is applicable while selling securities to RBI (daily injection of liquidity), while the reverse repo rate is applicable when banks buy back those securities (daily absorption of liquidity). Also, these interest rates fixed by the RBI also help in determining other market interest rates.

India experiences large capital inflows every day, and even though the OMO and the LAF policies were able to withhold the inflows, another instrument was needed to keep the liquidity intact. Thus, on the recommendations of the Working Group of RBI on instruments of sterilization (December, 2003), a new scheme known as the market stabilization scheme (MSS) was set up. The LAF and the OMO’s were dealing with day-to-day liquidity management, whereas the MSS was set up to sterilize the liquidity absorption and make it more enduring.

According to this scheme, the RBI issues additional T-bills and securities to absorb the liquidity. And the money goes into the Market Stabilization scheme Account (MSSA). The RBI cannot use this account for paying any interest or discounts and cannot credit any premiums to this account. The government, in collaboration with the RBI, fixes a ceiling amount on the issue of these instruments.

**Questions for self-control**

1. What are the goals of state regulation of foreign economic activity?
2. What are the principles of regulation of foreign economic activity?
3. What is the regulatory framework for foreign economic activity in Russia?
4. What is the main content of the law “On the Foundations of State Regulation of Foreign Economic Activity”?
5. What are the main areas regulated by the Customs Code?
6. What is the basis of customs and tariff regulation of foreign economic activity?
7. What is the customs tariff? Name its elements. What is a customs duty and what is its fundamental difference from other types of customs payments?
8. What are the types of rates of customs duties and who determines the size of these rates?

9. What are seasonal and special duties? What is the mechanism for establishing and collecting these fees?

10. What types of customs duties are applied in Russia? How does the size of the import duty rate depend on the country of origin of the goods?

11. What is a special protective measure?

12. When can an anti-dumping measure be applied to a product?

13. “Tariff benefits”, “tariff preferences” – the same thing? If not, then characterize each concept and show how they differ.
CONCLUSION

The process of location of foreign operation in a new country must be carried out carefully. Firm which aim to invest in foreign country need to make analysis of capital development, economic, political, culture, and legal stability not to make analysis on the risk involved in country. Almost of countries have risk in past. the investment of international firm bring changes in the situation. And country becomes economically stable. The country with risk has no competitor in the area. And with inter of international business it make positive impact. Create more employment, which increases consumption power of people. International business have high rate of profit. As the international business making contribution toward the economy of the country the government of host country give international business some relaxation in law and ensure him all kind of security as business need to do their operation.

In order to minimise risk in foreign operation international business need to inter into new county as trader (exporter-importer) or most commonly inter as joint venture with same size local company.
BIBLIOGRAPHIC LIST


FOREIGN ECONOMIC ACTIVITIES

Textbook