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Assessment of Contemporary Currency Regimes

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Abstract. The coronavirus pandemic causes a dramatically fall in global economic activity in recent history, with global GDP shrinking by 3.1%. Countries responded to this severe economic contraction with measures in the fiscal and financial sectors. For the first time, the central banks of the major member countries from the International Monetary Fund and some central banks of emerging market have adopted quantitative easing through asset purchase programs. Based on the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) provided by IMF, this paper assesses the four contemporary types of exchange rate regimes with literature study as the main researching method, countries which adopt different currency regimes are also listed. The future direction and problems of the EURO are discussed in the light of the theory of optimal currency areas. Meanwhile, the emerging currency markets represented by the CNY are studied, including the international trend of CNY.

Keywords: contemporary monetary system · soft pegs · EURO Area · internationalization of CNY

1 Introduction

The goal of establishing a monetary system is to secure the stability and circulation of money so that it can execute its many functions correctly and contribute to the creation of objective conditions favourable to economic progress. A good international monetary system is critical for maintaining the order and stability of international currency markets, encouraging balance of payments, and providing international credit in reaction to unexpected shocks. Previous studies have summarised the payment system as well as regulatory systems in the Eurozone and this report further discussed the problems in the Eurozone on the optimal currency area theory. At the same time, the internationalization opportunities and challenges of CNY after it gained Special Drawing Right (SDR) are also researched.

2 Classification of Contemporary Currency Regimes

Based on IMF staff analysis of information about members' de facto arrangements, exchange rates arrangements can be grouped into four categories.

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2.1 Category 1: Hard Pegs

The currency pegs shall be those in which the value of one country's currency is directly related to the value of another country's currency (or a basket of other currencies). Countries that use hard pegs have given up control over monetary policy. Countries that have adopted alternative national currencies are included in this category. It's uncommon to see changes taken place in this category because nations with such policies tend to keep their exchange rate regimes until their economies undergo some fundamental changes in structures which will force them out. For instance, 3.75 Saudi Riyal is always equal to one dollar in any case, which can be called a "hard peg".

2.2 Category 2: Soft Pegs

Soft pegs are also referred to fixed rates. It has five subcategories: conventional pegged arrangement, pegged exchange rate within horizontal bands, stabilized arrangement, crawling peg and crawl-like arrangement, they are distinguished by what is the currency fixed to, whether it is permitted to change—and if so, under what conditions—what sorts, amplitudes, and frequencies of intervention are allowed, and the degree of volatility it around the fixed rate.

Firstly, conventional pegged arrangement means a country's currency is formally pegged to another currency or a basket of currencies from significant financial or trading partners at a fixed rate. The country's authorities are prepared to intervene directly or indirectly to maintain the fixed parity. The currency rate may vary by $\pm 1\%$ around a central rate or by no more than 2% during a six-month period [1]. The exchange rate arrangement in Bahrain is a conventional peg arrangement. The dinar is pegged to the US dollar at the rate of BD 1 per US$2.659.

Secondly, pegged exchange rate within horizontal bands refers to the value of the currency is kept within 1% of the fixed central exchange rate or the difference between the maximum and minimum value of the exchange rate exceeds 2%. During the latest reporting period, only Morocco was classified in this category from 'stabilized'.

Thirdly, stabilized arrangement, which is a spot market rate that remains within a margin of 2% for six months or more and is not floating. Margin stability can be met by either a single currency or basket of currencies [2]. Exchange rate remains stable as a result of official action. The Singapore dollar has stabilized within a 2% band relative to the nominal effective exchange rate since February 2020. Thus, de facto exchange rate arrangements were reclassified from crawl-like to stabilized.

Fourth, the classification of crawling pegs means determining the legal exchange rate arrangements of national authorities. The currency is adjusted at a fixed exchange rate or according to the changes of selected quantitative indicators, such as the past inflation difference with major trading partners or the difference between the inflation target and expected inflation of major trading partners. Nicaragua is a typical country with a crawling peg arrangement. In November 2020, BCN lowered the crawling peg of córdoba against the US dollar from 3% to 2% annually.

Fifth, for categories classified as crawl-like arrangement, the exchange rate must remain within a narrow range of 2% with respect to a statistically defined trend for six months or more and the exchange agreement cannot be considered floating. The minimum rate of variation is higher than that allowed in a fixed agreement. Since November 2019, Ethiopia's exchange rate has increased its flexibility, but the exchange rate has depreciated within the 2% against the US dollar since February 2020. Two adjustments are planned, one in June 2020 and the other in August 2020, each within a period of six months.

A soft peg, as opposed to a hard peg, governments are able to take some actions or use some tools when solving economic shocks, this is kind of limited flexible monetary policy [3]. A fixed exchange rate can provide a currency some stability, making financial transactions more constant and controllable. However, regardless of whether the currency rises or falls, it will be influenced by the fixed (pegged) currency value.

2.3 Category 3: Floating Arrangements

Floating exchange rates are largely market-determined and there is no defined or predictable exchange rate channel. This kind of arrangements subdivided into free floating currencies, whose value is determined by open market forces and is not subject to government impact or intervention, and simple floating or intervention floating. Although the government and central banks do not totally set the floating exchange rate, they may nevertheless take some moves to keep the currency at a reasonable price for global commerce [2].

Floating exchange rates turns with the changes in supply-demand relationship of money, sometimes they may alter several times during one day. There are three main advantages of floating arrangements, firstly, it provides automatic correction of a balance of payments deficit. Secondly, floating rates allow transactions get rid of further control by the central bank or government throughout the progress [4]. Thirdly, central banks needn't hold large foreign currency reserves to balance exchange rates.

Whereas, floating rates show some clear disadvantages. Certainly, floating exchange rates are accompanied by large fluctuations in value which might lead to uncertainty and adverse effects for firms. What's more, limited economic development is in consequence of lacking strict control over the currency exchange rate.

2.4 Category 4: Residual

When the exchange rate arrangement does not fit the criteria for any of the other categories, the nation system might be categorized in this category. Kenya, and Uzbekistan are among the nations in this group that are transitioning to an inflation-targeting framework.

3 Monetary Policy Used by Euro Area

The creation of the EURO zone is the best practice of the optimal currency area (OCA) theory. Within this geographical area, it is believed that a single currency will help maximize welfare and achieve highest economic efficiency. According to Mundell, there are four criteria for an OCA, high labour mobility and capital liquidity across the region, financial risk-sharing systems, such as transfer payments in the OCA, highly correlated with economic development. The countries that joined the EURO zone did not implement the same budgetary controls, leading to a loss of investor confidence in international bond markets after many countries ran large fiscal deficits. Many economic crises had erupted such as the Greek debt problem.

The EURO area's unified payment system is called "target". A payment originator's bank and the beneficiary's bank no longer needed to have accounts with the same central bank in order for payments to be settled directly. Target contributed to the financial system's stability and this system provides convenience for interest rate arbitrage [5]. Furthermore, Banking Supervision Committee (BSC) of ECB is in charge of developing tools for predicting systemic weakness threats in particular.

After the global economic crisis, Greek debt, Irish woes and the Spanish real estate bubble, the EURO suffered a setback. Under the crisis of Covid-19 ECB has implemented its PEPP program, and its massive bond purchases have reduced the market's supply of safe EURO assets. The EURO System's balance sheet is already over €6 trillion; part of debt contributed by PEPP could be offset if the ECB issues its own deposit certificates. At the European level, concrete steps should be taken to build tools that are appealing to international reserve managers. This should benefit the global economy as well, because this would enhance the global supply of secure assets to some degrees [6].

4 Regime Choices in Emerging Market Countries

The structure of emerging markets differs from that of developed countries. This is typically linked to the worsening of financial frictions, the underdevelopment of financial markets, the high average level of dollarized assets, and asset management inequality [7]. As a result, nations of emerging markets must attach great importance to what monetary regimes bring.

There is an "Impossible Trinity" that can't be neglected when choosing currency regimes, the fixed exchange rate and the independence of monetary policy. Firstly, in order to maintain free capital flows and independence of monetary policy, exchange rate stability must be sacrificed and a floating exchange rate system should be implemented. For instance, Brazil officially implements a free-floating exchange rate mechanism. Brazil's Central Bank can intervene indirectly in the interbank settlement market for the final exchange rate. Secondly, controls on capital are necessary if stable exchange rates and monetary independence must be achieved. A relatively stable exchange rate contributes to maintaining external stability and an independent domestic monetary and interest rate policy helps to limit inflation and promote full employment. Independent monetary policy cannot be preserved if both free capital flows and exchange rate stability are required.

4.1 Currency Boards

The currency board ensures that the national monetary unit is stable. Because central banks do not always succeed in bringing order to cash credit procedures and relationships. This involves the establishment of a specific monetary system organization, usually known as a currency board [8]. In general, the currency board won't co-exist with central bank. For example, as the central bank failed to achieve the goal of its policy – to provide price stability, Bulgaria's Monetary Commission was established, and it was conducive to Bulgaria's accession to the EURO as soon as possible.

4.2 The Choice of RMB Exchange Rate System and Internationalization

Overall, managed floating is the de jure regime of China. Before 2015, China's exchange rate system was classified as crawl-like arrangement. Whereas, between 2016 and 2020, the classification of China regime had changed several times, such as 'stabilized arrangement', 'other managed arrangement' and 'crawl-like arrangement'. In the latest AREAER report for 2021, China's exchange rate system has been reclassified from other managed arrangement to 'crawl-like arrangement' again.

Since RMB joined SDR basket in 2016, it has been seeking opportunities for international development. This year, IMF announced on May 14 that they decided to maintain the current SDR basket composition and increase the weight of the USD and RMB from 41.73% and 10.92% to 43.38% and 12.28% respectively. This indicates that China's international trade status has been continuously improved, which provided a solid foundation for the international use of RMB. Meanwhile, the cooperation between China and developing countries has been enhanced, and the implementation of the "the Belt and Road" strategy has expanded the new market for RMB.

In 2018, as the foreign exchange market was generally running smoothly and the RMB exchange rate was based on market supply, and elasticity of RMB was increased, the People's Bank of China adjusted the foreign exchange risk reserve ratio for forward exchange sales business from 0 to 20%. This is reflected in the AREAER with 2019 as the perspective, where China's exchange rate regime classification changes from 'crawl-like arrangement' to 'other managed arrangement'. Since 2020, China's central bank has lowered the foreign exchange risk reserve ratio for forward sales business to zero, maintaining the stability of the RMB exchange rate at a equilibrium level and reducing the cost of foreign exchange purchases.

In recent years, China's exchange rate regime has gradually become more flexible, but the fact remains that there is still a gap between China's officially declared exchange rate regime and the one that actually operates. Domestic and foreign policies like OE policy of US and the cooperation with nations from European Union, all have a substantial impact on the RMB-related exchange rate, which is intimately tied to China's controlled floating exchange rate regime [9]. Apart from that, the monetary policy, exchange rate policy, and interest rate policy made by central banks all influence RMB exchange rate.

5 Conclusion

The global economy is moving towards integration so monetary policy choices of countries, especially the decisions of major economies, whether big or small, will have an influence on each other. It's impossible to find an ideal currency or figure out one certain exchange rate regime that is suit for all countries under any conditions. Countries must select the most appropriate exchange rate and related policies based on their national circumstances and financial environment. This paper discusses the classification of contemporary exchange regimes and uses representative cases to illustrate the trade-off among the three elements of ideal currency when choosing currency regimes. For example, the EURO must accelerate its recovery and resolve its members' debt crises, while the RMB must be prepared for the risks accompanied by internationalization. Lastly, for nations of emerging markets, learning more about changes of the economic environment can help them pick the right way of their exchange rate regime and will hopefully seize favourable opportunities in international investment and financial management and be full prepared when facing the challenges.

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