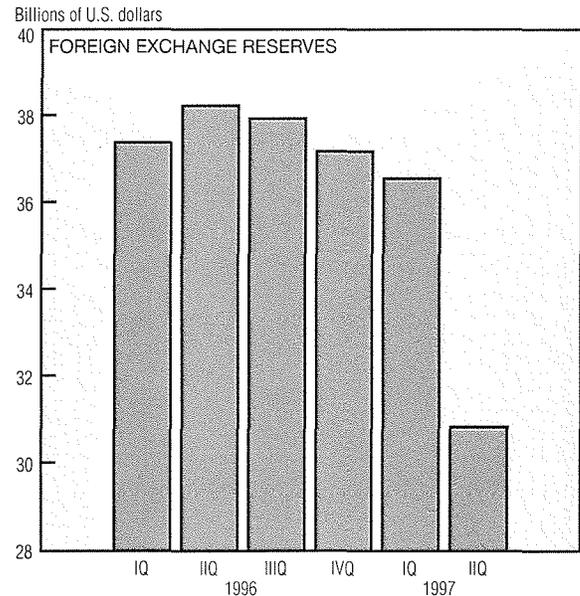
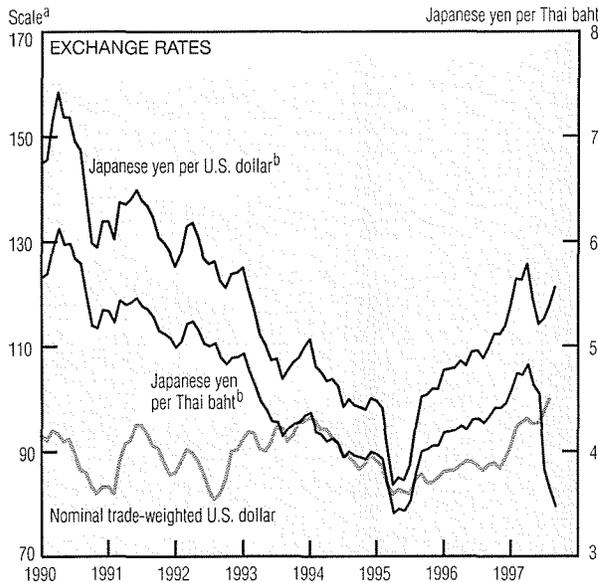
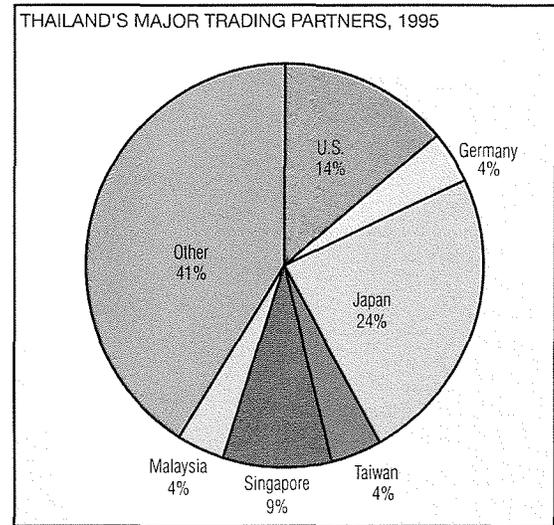
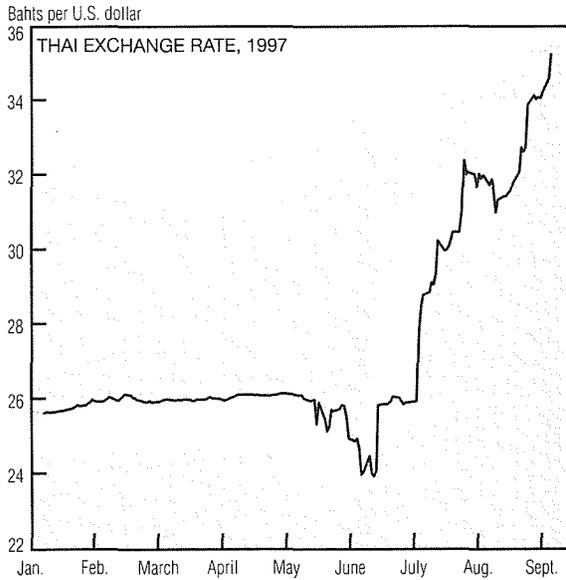


Fixed Exchange Rates: The Thai Baht



a. Japanese yen per U.S. dollar and the index value of the nominal trade-weighted U.S. dollar (March 1973 = 100).
 b. Monthly average of daily data.

SOURCES: Board of Governors of the Federal Reserve System; Morgan Stanley Capital International; and International Monetary Fund, *International Financial Statistics and Direction of Trade Statistics*.

Thailand, like many newly developing countries, closely links its currency to the U.S. dollar. By tying their currencies to that of a low-inflation industrialized country with a reputation for price stability—such as the U.S., Japan, or Germany—developing countries limit their ability to undertake discretionary monetary policies. The exchange rate then provides a visible check against inflation. In addition, fixed or stable exchange rates re-

duce the transaction costs associated with exchange rate volatility. This is particularly important to countries that rely heavily on international trade for economic growth, including Thailand.

These benefits entail some costs, however. If managed, an exchange rate cannot act as a buffer to economic shocks. In addition, the developing country may lose its competitive edge. Thailand conducts approximately 24% of its international trade with Japan. As the dollar

appreciated relative to the yen between early 1995 and early 1997, the baht followed.

To prevent its currency from depreciating in the face of capital flight, Thailand must sell its foreign exchange reserves for bahts. But foreign exchange reserves are limited. If the market believes that reserves are insufficient to meet the problem at hand, the fixed exchange rate provides speculators with a one-way bet on future exchange-rate movements.