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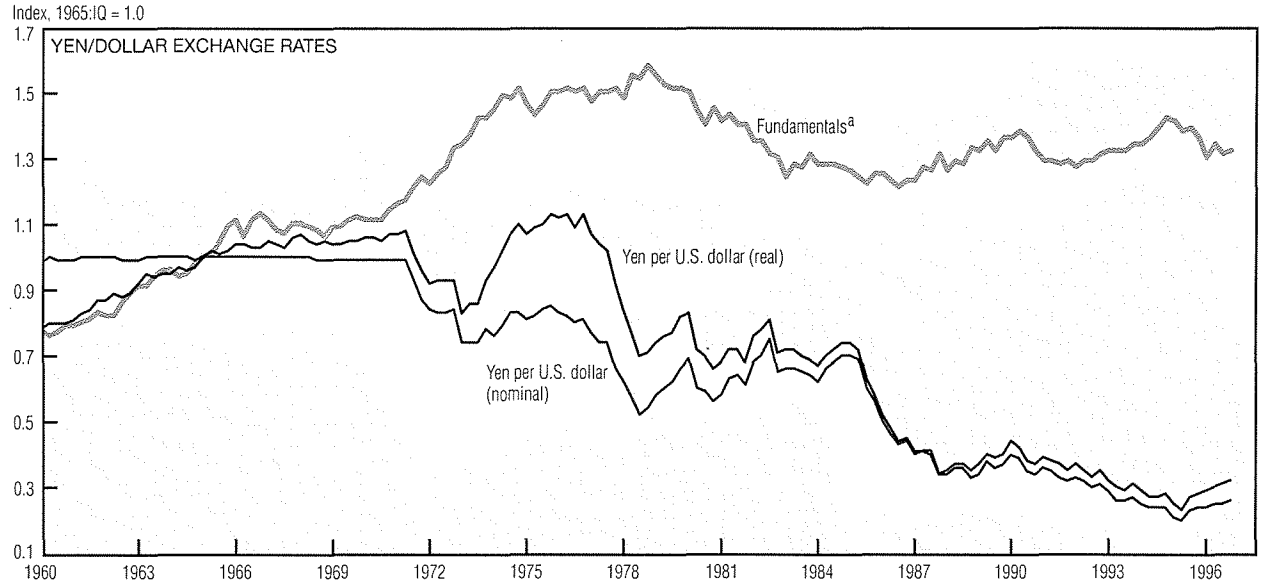
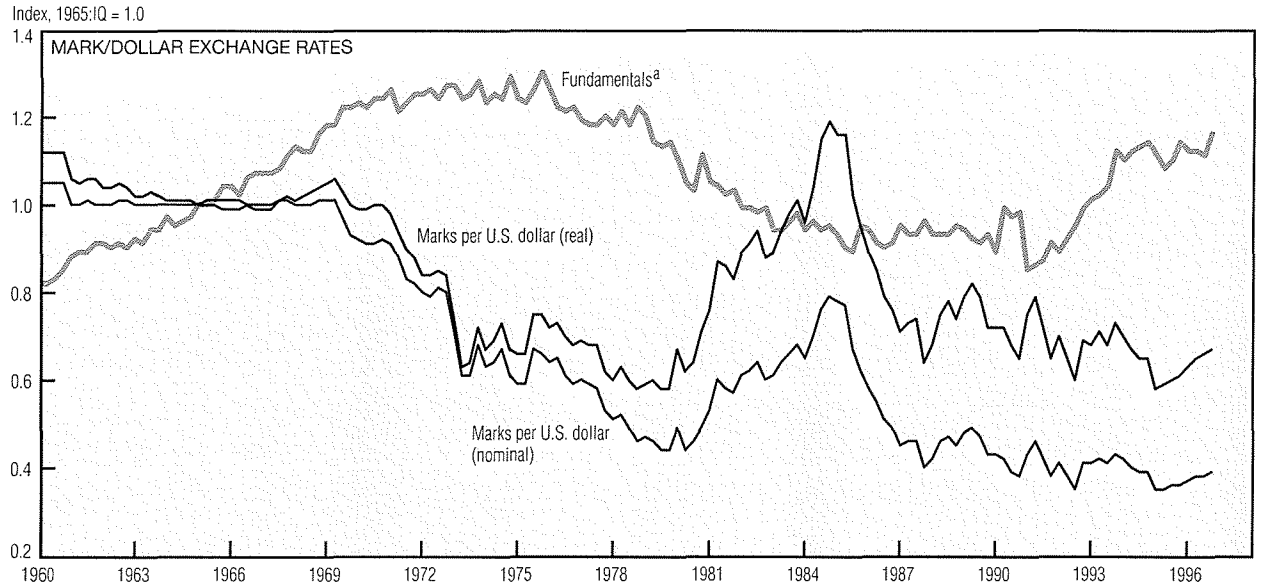
Floating Exchange Rates





a. Ratio of foreign M2 to output divided by U.S. M2 to output.
SOURCES: International Monetary Fund, *International Financial Statistics*; DRI/McGraw-Hill; and Jeffrey A. Frankel and Andrew K. Rose, "Empirical Research on Nominal Exchange Rates," in Gene M. Grossman and Kenneth Rogoff, eds., *Handbook of International Economics*, vol. 3, Amsterdam: Elsevier, 1995.

Since the end of the Bretton Woods fixed-exchange-rate regime, dollar exchange rates have moved in response to market forces. Isolating and explaining these forces is a task that still baffles economists.

An exchange rate is the relative price of one nation's currency in terms of another nation's currency. Accordingly, if the Federal Reserve creates excessive money (that is, more money than the public wants to hold) at a faster rate than does the Bundesbank or the Bank of Japan, the dollar will depreciate relative to the mark or yen. Theory notwithstanding, exchange rates do not move in close alignment with fundamental determinants of excessive money growth, except over long periods. This failure may reflect the crucial role of expectations in determining exchange rates. Foreign exchange traders face strong incentives to acquire all possible information about current and anticipated economic developments that might influence their quotes. To the extent that traders formulate their expectations without systematic errors, revisions will be random and will impart a zigzag pattern to exchange rate movements.

The tandem movements of nominal and real exchange rates are an additional puzzle. This correlation implies either that prices are sticky in the short run or that real economic shocks are more pervasive than previously thought.

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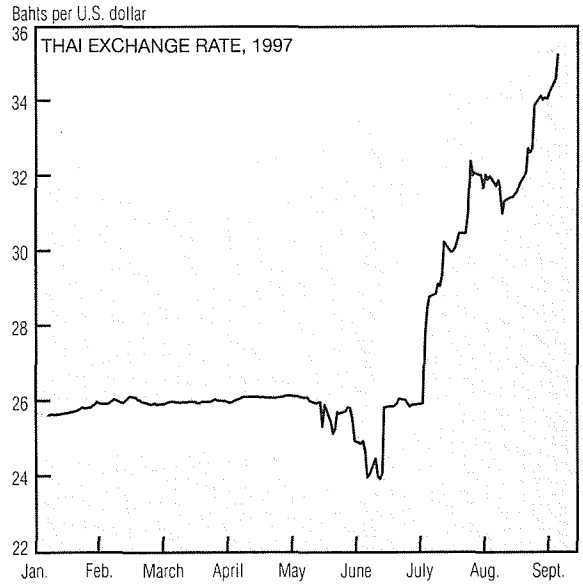
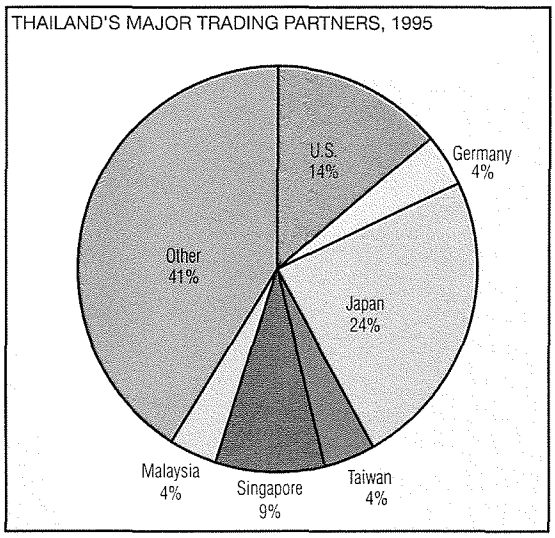
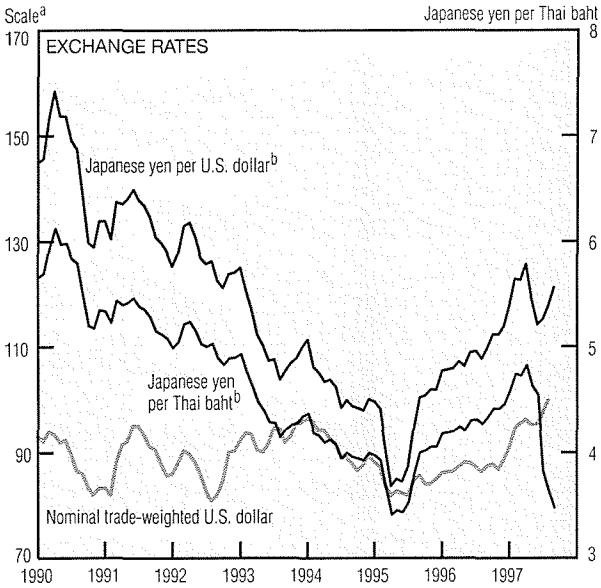
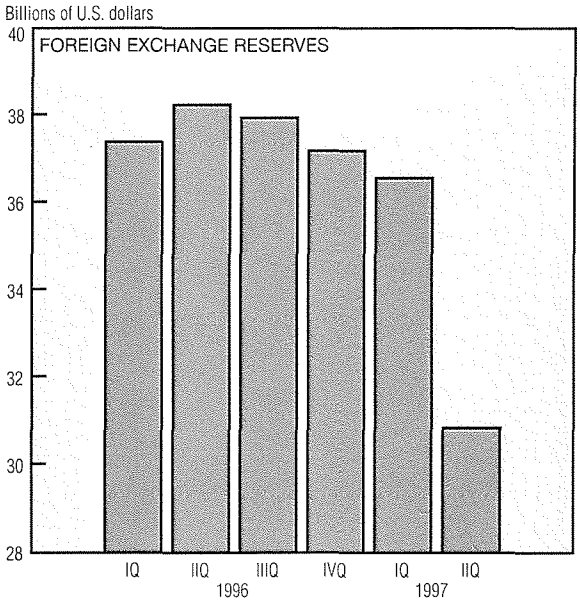
Fixed Exchange Rates: The Thai Baht









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 reduce 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.