CLASS 8

TOPIC	***Capital Mobility and Exchange Rate Regime***	
LEARNING CONTENT - DETAILED CHARACTERISTICS	We present currency convertibility and how it affects exchange rate regimes. We classify the exchange rate regimes into three main categories: hard pegs, intermediate regimes, and flexible regimes. International capital mobility and financial openness are considered. The pros and cons of capital mobility and exchange rate stability are discussed regarding the cost of investment, smoothing of consumption over time, and portfolio diversification. The link between exchange rate stability and trade, investment, and growth is empirically tested. We observe how capital mobility impacts the choice of an exchange rate regime. We consider currency crises and currency wars and comment on specific models for analyzing them. The pros and cons of capital openness are tracked and criteria for exchange rate regime choice have evolved over time. Policymakers often emphasize the credibility of exchange rate regime and the question if free floating really stabilize the economy.	
KEY WORDS	International capital mobility, financial openness, euroization, dollarization, monetary unions, conventional fixed peg, crawling peg, managed floating, free floating, credibility of exchange rate regime.	
SUGGESTED TOOLS	Power-point presentation Critical thinking and analysis Real-world personal observation Interactive and group discussions A personal study plan	
TIPS / METHODOLOGICAL REMARKS (if applicable)	Learning-by-doing and case studies activities. The focus is on the capital mobility and exchange rate regime choice and credibility.	
IMPLEMENTATION OF THE CLASSES	**STEP 1**	We consider the two important decisions governments must make: the conditions for exchanging the domestic currency for foreign currency (currency convertibility) and the extent of exchange rate flexibility (the exchange rate regime). The current account and financial account convertibility is distinguished.
	STEP 2	The exchange rate regimes classification is provided: hard pegs, intermediate regimes, and flexible regimes. We

Sofia University "St.Kliment Ohridski"
15 Tzar Osvoboditel blvd
1504 Sofia, Bulgaria
e-mail: mmtocheva@uni-sofia.bg
https://www.uni-sofia.bg

		comment on their advantages and disadvantages. A country classification is considered. See work card 1.
	STEP 3	We discuss pros and cons of capital mobility and exchange rate stability. Some empirical evidence for the mixed effect of capital mobility is provided.
	STEP 4	The three generations of models of currency crises are considered. Currency crises and currency wars are distinguished. The model of a self-fulfilling currency crisis and the model of early warning indicators are commented.
	STEP 5	The students take note that the first choice when it comes to exchange rates and financial integration is the joint choice of an exchange rate regime and a degree of capital mobility. If capital is highly mobile internationally, then a government must choose between a fixed exchange rate with no monetary independence or a flexible exchange rate with monetary independence. Therefore, the credibility of exchange rate regime is of utmost importance.

ADITIONAL MATERIAL 1 (WORK CARD, PICTURE, RECORDING, QUIZZ, PRESENTATION, ASSIGNEMENTS)

WORK CARD 1 – CAPITAL MOBILITY AND EXCHANGE RATE REGIME

Benassy-Quere et al. (2019, pp. 471) presents the following table regarding the benefits and costs of three exchange rate regimes:

	Benefits	Costs
Flexible exchange rate	➢ Independent instrument of macroeconomic adjustment in case of an asymmetric shock ➢ Effectiveness of monetary policy	➢ Instability if relative prices related to nominal exchange rate volatility ➢ Risk of currency wars in case of a symmetric shock

Sofia University "St.Kliment Ohridski"
15 Tzar Osvoboditel blvd
1504 Sofia, Bulgaria
e-mail: mmtocheva@uni-sofia.bg
https://www.uni-sofia.bg

Conventional fixed peg	➢ Limited instability of relative prices due to low exchange rate volatility ➢ Nominal anchor for price expectation ➢ Effectiveness of fiscal policy	➢ Loss of an instrument of adjustment in case of asymmetric shock ➢ Risk of inadequate monetary policy ➢ Risk of currency crisis
Monetary union	➢ Elimination of transaction costs related to currency exchanges ➢ Limited instability if relative prices ➢ Nominal anchor for price expectations ➢ Effectiveness of fiscal policy due to limited crowding out ➢ Coordinated monetary policy in case of a symmetric shock	➢ Irrevocable loss of an instrument of adjustment in case of asymmetric shock ➢ Risk of inadequate monetary policy

Answer the following questions:

1) What is your opinion on the benefits and cost of different exchange rate regimes? Do you agree or disagree?
2) Which exchange rate regime is preferable for your country? Why?
3) What is your country's experience following the established exchange rate regime? What were the reasons this exchange rate regime to be established?
4) What do you think about the monetary union exchange rate regime? Give some examples to support your opinion.
5) How do the abovementioned benefits and costs of exchange rate regimes impact the criteria for choosing an exchange rate regime?

ADITIONAL MATERIAL 2 (WORK CARD, PICTURE, RECORDING, QUIZZ, PRESENTATION, ASSIGNEMENTS)

WORK CARD 2 – CAPITAL MOBILITY AND EXCHANGE RATE REGIME

Watch the video *How The US-China Trade War Turned Into A Currency War:*
https://www.youtube.com/watch?v=RP_TUhltGZk

How The US-China Trade War Turned Into A Currency War

Discuss the trade and financial relations between the USA and China. How do you think they will develop in the future? What will be the main lines of agreement and contradiction between the two major economies in the future? What other examples of currency wars can you provide?

Sofia University "St.Kliment Ohridski"
15 Tzar Osvoboditel blvd
1504 Sofia, Bulgaria
e-mail: mmtocheva@uni-sofia.bg
https://www.uni-sofia.bg