CHAPTER 2

LITERATURE REVIEW

2.0 Exchange Rate Regimes and Trade

"Economists and policymakers often refer to the exchange rates as a key macroeconomic variable. As a relative price, the exchange rate plays a crucial role in theoretical models and open economy and transactions between countries" (Chinn 2002: 1). "Hence, the exchange rate is a highly visible indicator and a key policy variable in determining a country's economic well being" (Rana 1999). Therefore, the impact of exchange rate regimes on international trade would be quite significant.

Based on traditional economic theory, "the advantage of fixed exchange rates for any country is that it will help reduce transactions costs and exchange rate risk which thus encourages trade and investment and also provides a credible nominal anchor for monetary policy" (Frankel 1999). A fixed exchange rate system would help contract domestic inflation. However, for some economists, the impact of exchange rate volatility on trade still remains unclear as such currency pegs may have some negative effects.

On the other hand, "the big advantage of a floating exchange rate is the ability to pursue an independent monetary policy" (Frankel 1999). Monetary policies can be implemented based on current economic situations. But a floating exchange rate system has also some disadvantages due to the volatility in the foreign exchange market. "Increased volatility in exchange rates cause uncertainty for the future behaviour of exchange rates. In other words, uncertainty in exchange rates contains risks. Therefore, it is widely believed that increased volatility in exchange rate has had an adverse effect on international trade" (Doğanlar 2002; Hitiris 1988).