CHAPTER 3

HISTORICAL BACKGROUND

3.0 Exchange Rate Arrangements

Economic theory identifies two types of exchange rate arrangements: the fixed exchange rate regime and the floating or flexible exchange rate regime. Under the fixed exchange rate regime, nations fix the value of their currencies to that of another country such as the sterling or the dollar. Whereas, the floating exchange rate regime is a system where market forces determine the exchange rate. Thus, the floating exchange rate regime allows the exchange rate to float freely against other currencies.

In the present years, other alternative exchange rate arrangements have been implemented in some countries. Most of these alternative arrangements could be characterised as fixed but adjustable exchange rate regimes as explained below:

a. *Crawling peg*

The home currency is fixed in terms of another but is adjusted periodically in small amounts to reflect supply and demand pressures.

b. *Currency board*

Mishkin (2003: 512) defines the currency board as a system in which the home currency is backed 100 per cent by a foreign currency (example, US dollars). Thus, monetary authorities establish a fixed exchange rate with the dollar and exchange the home currency at this fixed rate.

c. *Exchange rate band*

The central bank intervenes in the foreign exchange market to maintain the nominal exchange rate within a band of prescribed range around a central rate. Hence, the