Currency Pegs

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In the rise and fall of world powers, the currency market keeps score. A nation's money gains value when it's a magnet for global investors; in times of trouble it weakens. The volatility can create havoc. To keep things in check, more than half of all countries have fixed the value of their money to another currency — mostly the U.S. dollar or the euro. They've hammered in a peg. The tie-ups can provide stability and foster trade, as Hong Kong's link to the dollar has since 1983. Until they don't. To hold most pegs in place, central banks must deploy foreign reserves, buying and selling in currency markets in a battle with traders to keep exchange rates stable. If pressure builds, they'll be forced to give up. The peg will slip or break — with sometimes disastrous consequences.

The Situation

Some currencies linked to the dollar came under attack in early 2016 from traders speculating that it's becoming too expensive to continue defending them. The slowdown in China's economy put pressure on Hong Kong's peg, while Saudi Arabia cracked down on bets against the riyal after the collapse in oil prices. Currency markets have been roiled since August, when China cut the value of the yuan for the first time in two decades; the country burned through more than $500 billion of its reserves in 2015. Both Egypt and Nigeria also effectively devalued last year, as did Argentina. Switzerland shocked traders by scrapping the franc's three-year-old cap against the euro in early 2015, which forced the central bank in Denmark to defend the krone's tie-up to the euro. Though the currencies of most large countries and the 19-nation euro float freely, the trend has been heading the other way: 35 percent of countries monitored by the International Monetary Fund gave the market free rein in 2015, down from 40 percent in 2008.

Preferring Pegs

Some managed exchange rates

Currency Pegs

Country	Pegged to	Since When	Notes
Hong Kong	U.S. dollar	1983	currency board
Denmark	euro (deutsche mark)	1982	backed by the European Central Bank
Saudi Arabia	U.S. dollar	1986	
Venezuela	U.S. dollar	2003	controls dollar sales at various official rates

Other Arrangements

Country	Linked to	Since When	Notes
China	basket of currencies	2005	2 percent trading band around daily fix; limited convertibility
Malaysia	basket of currencies	2005	intervenes to smooth volatility
Singapore	trade-weighted basket	1981	managed within trading band
Egypt	U.S. dollar	2003	trading restricted to official rate

Source: IMF, Bloomberg News

The Background

There are various systems for managing exchange rates, and some are more stable than others. Panama and Zimbabwe simply use the U.S. dollar as legal tender. Fixed rates are employed in countries from Bulgaria to Saudi Arabia to Venezuela. Singapore and China have employed different types of links to currencies of trading partners via bands that can move up or down. China has mostly used the arrangement to limit appreciation over the last decade, though it's now allowing the yuan to fluctuate more in response to market forces. Hong Kong's peg has been seen as virtually impregnable because the total amount of local currency issued is backed by U.S. dollars in reserve, an arrangement known as a currency board. History is full of upheavals. The 1971 "Nixon shock" was sparked when President Richard Nixon abruptly ended the dollar's convertibility to gold. It led to the end of the post-World-War-II Bretton Woods system that pegged currencies of industrialized countries to the U.S. The U.K. faced a storm in 1992, when investors including George Soros bet it wouldn't be able to keep its pound within a pre-euro system of linked rates. It gave in on Sept. 16 and allowed the pound to float, a day known as Black Wednesday.

The Argument

Currency pegs put a central bank at the mercy of another country's monetary and fiscal policy, so it must generally copy moves on interest rates. There's less freedom to respond to domestic goals, such as reviving growth, creating jobs or containing prices. In Hong Kong, for example, easy-money policies in the U.S. caused a surge in inflation and home prices. So why peg? More predictability for companies and investors. Tying policy makers' hands can also lead to more disciplined government spending. For a peg to hold, the exchange rate must be set judiciously and kept in line. Since there's no automatic rebalancing from trade flows, it's easy for a peg to get out of whack. That can cause a currency to lose credibility and come under attack. Some countries -– like China, Egypt and Venezuela -– keep speculators at bay with capital controls that limit how much currency can be converted or rules that require banks to trade near official rates.

**Note- Egypt has since dropped its peg to the US dollar in November 2016, under loan condition pressure by the IMF