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How Do Other Countries Devalue Their Currencies?

By Sam Vaknin, Ph.D.

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Countries devalue their currencies only when they have no other way to correct past economic mistakes - whether their own or mistakes committed by their predecessors.

The ills of a devaluation are still at least equal to its advantages.

True, it does encourage exports and discourage imports to some extents and for a limited period of time. As the devaluation is manifested in a higher inflation, even this temporary relief is eroded. In a previous article in this paper I described WHY governments resort to such a drastic measure. This article will deal with HOW they do it.

A government can be forced into a devaluation by an ominous trade deficit. Thailand, Mexico, the Czech Republic - all devalued strongly, willingly or unwillingly, after their trade deficits exceeded 8% of the GDP. It can decide to devalue as part of an economic package of measures which is likely to include a freeze on wages, on government expenses and on fees charged by the government for the provision of public services. This, partly, has been the case in Macedonia. In extreme cases and when the government refuses to respond to market signals of economic distress - it may be forced into devaluation. International and local speculators will buy foreign exchange from the government until its reserves are depleted and it has no money even to import basic staples and other necessities.

Thus coerced, the government has no choice but to devalue and buy back dearly the foreign exchange that it has sold to the speculators cheaply.

In general, there are two known exchange rate systems: the floating and the fixed.

In the floating system, the local currency is allowed to fluctuate freely against other currencies and its exchange rate is determined by market forces within a loosely regulated foreign exchange domestic (or international) market. Such currencies need not necessarily be fully convertible but some measure of free convertibility is a sine qua non.

In the fixed system, the rates are centrally determined (usually by the Central Bank or by the Currency Board where it supplants this function of the Central Bank). The rates are determined periodically (normally, daily) and revolve around a "peg" with very tiny

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variations.

Life being more complicated than any economic system, there are no "pure cases".

Even in floating rate systems, Central banks intervene to protect their currencies or to move them to an exchange rate deemed favourable (to the country's economy) or "fair". The market's invisible hand is often handcuffed by "We-Know-Better" Central Bankers. This usually leads to disastrous (and breathtakingly costly) consequences. Suffice it to mention the Pound Sterling debacle in 1992 and the billion dollars made overnight by the arbitrageur-speculator Soros - both a direct result of such misguided policy and hubris.

Floating rates are considered a protection against deteriorating terms of trade.

If export prices fall or import prices surge - the exchange rate will adjust itself to reflect the new flows of currencies. The resulting devaluation will restore the equilibrium.

Floating rates are also good as a protection against "hot" (speculative) foreign capital looking to make a quick killing and vanish. As they buy the currency, speculators will have to pay more expensively, due to an upward adjustment in the exchange rates. Conversely, when they will try to cash their profits, they will be penalized by a new exchange rate.

So, floating rates are ideal for countries with volatile export prices and speculative capital flows. This characterizes most of the emerging economies (also known as the Third World).

It looks surprising that only a very small minority of these states has them until one recalls their high rates of inflation. Nothing like a fixed rate (coupled with consistent and prudent economic policies) to quell inflationary expectations. Pegged rates also help maintain a constant level of foreign exchange reserves, at least as long as the government does not stray from sound macro-economic management. It is impossible to over-estimate the importance of the stability and predictability which are a result of fixed rates: investors, businessmen and traders can plan ahead, protect themselves by hedging and concentrate on long term growth.

It is not that a fixed exchange rate is forever. Currencies - in all types of rate determination systems - move against one another to reflect new economic realities or expectations regarding such realities. Only the pace of changing the exchange rates is different.

Countries have invented numerous mechanisms to deal with exchange rates fluctuations.

Many countries (Argentina, Bulgaria) have currency boards. This mechanism ensures that all the local currency in circulation is covered by foreign exchange reserves in the coffers of the Central bank. All, government, and Central Bank alike - cannot print money and must operate within the straitjacket.

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Other countries peg their currency to a basket of currencies. The composition of this basket is supposed to reflect the composition of the country's international trade. Unfortunately, it rarely does and when it does, it is rarely updated (as is the case in Israel). Most countries peg their currencies to arbitrary baskets of currencies in which the dominant currency is a "hard, reputable" currency such as the US dollar. This is the case with the Thai baht.

In Slovakia the basket is made up of two currencies only (40% dollar and 60% DEM) and the Slovak crown is free to move 7% up and down, around the basket-peg.

Some countries have a "crawling peg". This is an exchange rate, linked to other currencies, which is fractionally changed daily. The currency is devalued at a rate set in advance and made known to the public (transparent). A close variant is the "crawling band" (used in Israel and in some countries in South America). The exchange rate is allowed to move within a band, above and below a central peg which, in itself depreciates daily at a preset rate.

This pre-determined rate reflects a planned real devaluation over and above the inflation rate.

It denotes the country's intention to encourage its exports without rocking the whole monetary boat. It also signals to the markets that the government is bent on taming inflation.

So, there is no agreement among economists. It is clear that fixed rate systems have cut down inflation almost miraculously. The example of Argentina is prominent: from 27% a month (1991) to 1% a year (1997)!!!

The problem is that this system creates a growing disparity between the stable exchange rate - and the level of inflation which goes down slowly. This, in effect, is the opposite of devaluation - the local currency appreciates, becomes stronger. Real exchange rates strengthen by 42% (the Czech Republic), 26% (Brazil), even 50% (Israel until lately, despite the fact that the exchange rate system there is hardly fixed). This has a disastrous effect on the trade deficit: it balloons and consumes 4-10% of the GDP.

This phenomenon does not happen in non-fixed systems. Especially benign are the crawling peg and the crawling band systems which keep apace with inflation and do not let the currency appreciate against the currencies of major trading partners. Even then, the important question is the composition of the pegging basket. If the exchange rate is linked to one major currency - the local currency will appreciate and depreciate together with that major currency. In a way the inflation of the major currency is thus imported through the foreign exchange mechanism. This is what happened in Thailand when the dollar got stronger in the world markets.

In other words, the design of the pegging and exchange rate system is the crucial element.

In a crawling band system - the wider the band, the less the volatility of the exchange

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rate. This European Monetary System (EMS - ERM), known as "The Snake", had to realign itself a few times during the 1990s and each time the solution was to widen the bands within which the exchange rates were allowed to fluctuate. Israel had to do it twice. On June 18th, the band was doubled and the Shekel can go up and down by 10% in each direction.

But fixed exchange rates offer other problems. The strengthening real exchange rate attracts foreign capital. This is not the kind of foreign capital that countries are looking for. It is not Foreign Direct Investment (FDI). It is speculative, hot money in pursuit of ever higher returns. It aims to benefit from the stability of the exchange rate - and from the high interest rates paid on deposits in local currency.

Let us study an example: if a foreign investor were to convert 100,000 DEM to Israeli Shekels last year and invest them in a liquid deposit with an Israeli bank - he will have ended up earning an interest rate of 12% annually. The exchange rate did not change appreciably - so he would have needed the same amount of Shekels to buy his DEM back. On his Shekel deposit he would have earned between 12-16%, all net, tax free profit.

No wonder that Israel's foreign exchange reserves doubled themselves in the preceding 18 months. This phenomenon happened all over the globe, from Mexico to Thailand.

This kind of foreign capital expands the money supply (it is converted to local currency) and - when it suddenly evaporates - prices and wages collapse. Thus it tends to exacerbate the natural inflationary-deflationary cycles in emerging economies. Measures like control on capital inflows, taxing them are useless in a global economy with global capital markets.

They also deter foreign investors and distort the allocation of economic resources.

The other option is "sterilization": selling government bonds and thus absorbing the monetary overflow or maintaining high interest rates to prevent a capital drain. Both measures have adverse economic effects, tend to corrupt and destroy the banking and financial infrastructure and are expensive while bringing only temporary relief.

Where floating rate systems are applied, wages and prices can move freely. The market mechanisms are trusted to adjust the exchange rates. In fixed rate systems, taxes move freely. The state, having voluntarily given up one of the tools used in fine tuning the economy (the exchange rate) - must resort to fiscal rigor, tightening fiscal policy (=collect more taxes) to absorb liquidity and rein in demand when foreign capital comes flowing in.

In the absence of fiscal discipline, a fixed exchange rate will explode in the face of the decision makers either in the form of forced devaluation or in the form of massive capital outflows.

After all, what is wrong with volatile exchange rates? Why must they be fixed, save for psychological reasons? The West has never prospered as it does nowadays, in the era of floating rates. Trade, investment - all the areas of economic activity which were

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supposed to be influenced by exchange rate volatility - are experiencing a continuous big bang. That daily small fluctuations (even in a devaluation trend) are better than a big one time devaluation in restoring investor and business confidence is an axiom. That there is no such thing as a pure floating rate system (Central Banks always intervene to limit what they regard as excessive fluctuations) - is also agreed on all economists.

That exchange rate management is no substitute for sound macro- and micro-economic practices and policies - is the most important lesson. After all, a currency is the reflection of the country in which it is legal tender. It stores all the data about that country and their appraisal. A currency is a unique package of past and future with serious implications on the present.

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Currencies, Taxes and Citizenship by William Cate

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By William Cate
July 2004
[http://home.earthlink.net/~beowulfinvestments/]
[http://home.earthlink.net/~beowulfinvestments/globalvillageinvestmentclubwelcome/]

Would you accept 1,185,000,000 Tugriks for your company? If you invested in a company, would you accept repayment of your investment and profits in Tugriks? Outside of Mongolia, where the Tugrik is the national currency, the answer would be NO!

Acceptable International Currencies

Today, there are five major world currencies: the U.S. Dollar, the British Pound, the Japanese Yen, the Euro and the Swiss Franc. Payments in any of these five currencies are acceptable almost everywhere in the World.

There is a secondary tier of about twenty semi-acceptable world currencies, like the Canadian Dollar. They can be used in international business because they can be converted into the five major world currencies without the issuing Government's review of the currency transaction and the Government's potential intervention and termination of the payment.

Back to Tugriks

If you have a feed business in Ulan Bator, Tugriks are great. If you expect to die in Mongolia and have your children manage your feed business, Tugriks are terrific. However, if you want to expand your feed business into Russia or the PRC, Tugriks become a serious handicap to your plans. If you want to send your children to Cambridge, the registrar won't accept Tugriks for their tuition. Should you decide that the Mongolian Winters are more than you care to withstand in your old age, you can't use Tugriks to relocate to the South Pacific.

Assuming that you have average intelligence and a global vision, you'll do business in a major world currency. It's the only way that your company can grow beyond your national borders. It's the only way that you, your family and heirs will survive comfortable for the next hundred years. There is a saying in the States that few people heed. Don't put all your eggs in one basket. History teaches us that eventually political, economic and social upheaval destroy any basket (country).

Taxation Is Not Uniform Around the World

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In the 11th Century, Robinhood fled to Sherwood Forest, objecting to a 20% Government income tax rate. A millennium later, the income tax rate in the UK is 50% and nobody knows the exact location of Sherwood Forest. This isn't progress.

At this time, you can find your Sherwood Forest in Belize, Nevis, the Cayman's, Nuie, the Bahamas and a list of low tax countries. If you have a global business, it must be located in a low tax country to maximize your profits. If you want to maximize your income, your investment profits must be taken in a country that will tax them least. I'm among the guides to the modern Sherwood Forests. If you don't see the logic in operating from Sherwood Forest, you can't succeed in the Global Village.

Citizenship is Your Choice

You had no control over where you were born. As an adult, you have every right to determine your citizenship. You formed your company in some country. You have every right to move it to whatever country best services your needs. If you intend to operate a Global Business as an International Citizen, you should do both.

I favor Belize for your corporate jurisdiction. Taxes are extremely low on non-Belize business income. I favor Canada as a better citizenship location. You must make an investment in Canada to become a citizen. You must live in Canada for three years. Currently, nobody in the world is upset with the Canadians. The Canadian offer is worth considering for most business people.

Citizenship and Taxation

I know a Canadian attorney, who can secure Landed Immigrant Status for most families whose members lack criminal records and are HIV negative. Canada offers a five-year tax holiday for new citizens. So, you won't be taxed during the period that you must reside in Canada to obtain your citizenship.

Canada doesn't tax its nationals who are not living in Canada. You can avoid income taxes by leaving Canada with your new Canadian passport and living in any country that doesn't tax foreign-source income. Few countries tax foreign-source income of their non-citizen residents. So, you can live almost anywhere probably including your country of birth.

A global vision requires that you use a major world currency. You must seek the lowest legal tax rates on your income and that of your company. You should consider adjusting your citizenship to one that is more in tune with your international reality.

To contact the author: Visit the Beowulf Investments website: [http://home.earthlink.net/~beowulfinvestments/] Or, visit the Global Village Investment Club Website: [http://home.earthlink.net/~beowulfinvestments/globalvillageinvestmentclubwelcome/]

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