

The Peg and the Strength of the EC Dollar

What is Currency Pegging?

Currency pegging simply means that a country fixes the exchange rate of its currency to the currency of another country.

In the case of the Eastern Caribbean Currency Union, the EC dollar has been fixed to the US dollar at a rate of EC\$2.70 to US\$1.00 since 1976. Prior to this the EC currency was fixed to the pound sterling at an exchange rate of EC\$4.80 to £1.00. However, following the sterling's depreciation (*decline in value*) in the 1970's, the decision was made to shift the peg to the US dollar.

Any decision to alter the peg of the EC currency rests with the Monetary Council, the highest decision making body of the Eastern Caribbean Central Bank (ECCB).

Implications of the Peg

The pegging of the EC currency to the US currency implies that when the value of the US dollar fluctuates relative to other currencies, the EC dollar undergoes a similar fluctuation in value relative to other currencies.

Let us take for example the case of the pound sterling. During the first and second weeks of February 2004, reports indicated that the pound sterling appreciated (*rose in value*) against the US dollar. The actual rate moved from US\$ 1.8477 to £1.00 on February 6th 2004 to US\$ 1.8852 to £1.00 on February 13th 2004. Similarly the EC dollar moved from a rate of EC\$ 4.9888 to £1.00 to a rate of EC\$ 5.0900 to £1.00 over the same period.

In this scenario, where the pound sterling rises in value against the US dollar and by extension against the EC dollar, it means that citizens of the Eastern Caribbean Currency Union (ECCU) would benefit if they were in receipt of pounds and were able to convert them to EC dollars at the higher exchange rate. Additionally, receipts from ECCU exports denominated in pound sterling, would upon conversion into EC dollars, be larger.

On the flip side however, persons who have to convert EC dollars to pounds to pay, for example, college tuition in the UK, or ECCU member governments who have to repay loans denominated in pound sterling would be at a disadvantage. This is because it would require more EC dollars to purchase the required amount of pound sterling.

Rationale For The Peg

In the case of the ECCU, the rationale for pegging the EC currency to the US currency is the fact that most of the external trade and financial (capital) flows are carried out with the United States. When the region engages in US\$ denominated transactions, whether trade or credit (loans), the peg eliminates uncertainty in the prices of goods and services and the value of debts due to fluctuations in the value of the currency. Simply put, the US dollar acts as an anchor for the EC dollar.

Moreover, by providing certainty as to the value of the EC dollar relative to the US dollar, the pegging of the EC currency allows foreigners to have confidence in the currency of the region. Confidence in the EC dollar, has also been a significant deterrent to capital flight and to a preference for the holding of foreign currency over the EC currency.

Other Exchange Rate Regimes

The opposite of a fixed exchange rate regime is a flexible exchange rate regime. Such flexibility can range from a “free floating currency” regime where the value of the currency fluctuates according to market forces to a “managed float” that permits the value of the currency to move within a set range.

In a free-floating currency regime, the prices of imported goods as well as local goods requiring foreign inputs will most likely fluctuate in tandem with, but in the opposite direction to, the changes in the value of the local currency. In such a scenario, the

consumer will have to continuously reassess the amount of goods and services that his wages can provide.

Conclusion

The EC dollar fixed exchange regime, with the EC currency pegged to the US dollar at a rate of EC\$2.70 to US\$1.00, has served the region well. The region has historically enjoyed a relatively low rate of inflation, incremental improvements in the standards of living for its people and economic stability.