contagion effect arising from a speculative attack on its neighbour. If the country is unwilling to raise interest rates sufficiently in this situation, it may be forced to devalue and, thus, confirm the expectation that initially triggered the attack on its currency.

2.4. Target Zones

An alternative form of the fixed exchange rate system is to allow wide bands around the announced parity. This regime—generally referred to as a target zone—is claimed to provide more room for monetary policy to manoeuvre without producing excessive fluctuations in the exchange rate. The target zone is thus thought to represent a happy compromise between rigidly fixed and uncontrolled flexible exchange rates. This regime has been analyzed extensively in the literature. The basic analysis assumes that the central bank is fully committed to keeping the exchange rate within the specified band, and intervenes effectively at the edges of the band.[7] A key result of this analysis is that the expectation of full commitment to intervention at the boundaries stabilizes intraband movements of the exchange rate.

- The result that target zones are inherently stable is, however, extremely sensitive to the assumption that this regime is credible.

The credibility of the regime would be undermined if macro-economic conditions or political pressures induce the country to follow policies that are inconsistent with the fixed parity. Expectations of a change in the parity would make the country prone to speculative attacks. A wide exchange rate band may delay but would not prevent currency crises. Once an attack on the currency starts, the country would experience the same speculative pressures and face the same policy dilemma regardless of whether the band is wide or narrow. To forestall a speculative attack, the central bank may even attempt to influence the exchange rate before it gets close to the boundaries of the target zone. In such a case, the target-zone regime would play-out much like a managed flexible exchange rate regime.

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[7] See Paul R. Krugman, "Target Zones and Exchange Rate Dynamics", **Quarterly Journal of Economics**, 106, 1991, 669-82.