

Currency Substitution and Models of Exchange Rate Determination

**By Eric J. Pentecost
Loughborough University**

ABSTRACT

This paper presents a critical review of currency substitution in the context of econometric models of exchange rate determination. The paper begins by examining the concept of currency substitution and the motivations for domestic residents' holding's of foreign currency. A number of potential measures of the determinants of the changes in these foreign money balances are then evaluated in the context of models of exchange rate determination. The conclusions are first, that the degree of currency substitution is not independent of the degree of financial and goods markets integration. Second, that the traditional measures of currency substitution, such as the interest rate differential or the expected inflation differential are inadequate in economies with developed financial market as a measures of currency substitution. Third, the real exchange rate may provide a better indicator of currency substitution, if foreign money balances are held by domestic residents in order to finance imports.