

15.1: Overview of Fixed versus Floating Exchange Rates

Learning Objective

1. Preview the discussion about fixed versus floating exchange rate systems.

This chapter addresses what is perhaps the most important policy issue in international finance: to have fixed or floating exchange rates. The chapter focuses on three main features that affect the choice of system: volatility and risk, inflationary consequences, and monetary autonomy.

Volatility and risk refers to the tendency for exchange rates to change and the effect these changes have on the risk faced by traders and investors. Although in floating exchange systems volatility is a natural day-to-day occurrence, even in fixed exchange systems, devaluations or revaluations make volatility an issue. This chapter compares the two systems in light of this issue.

Inflationary consequences are shown to be a major potential problem for countries with floating exchange rates. For many countries facing this problem, fixed exchange rate systems can provide relief. The section shows that the relationship between inflation and the exchange rate system is an important element in the choice of system.

Finally, monetary autonomy, and the ability to control the economy, is lost with the choice of fixed exchange rates. We discuss why this loss of autonomy can be problematic in some circumstances but not in others.

The chapter concludes by providing some answers to the policy question, “fixed or floating?”

Key Takeaways

- Three main features affect the choice of the exchange rate system: volatility and risk, inflationary consequences, and monetary autonomy.
- The choice between fixed and floating exchange rates is one of the most important policy decisions in international finance.

exercise

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
 - The choice between these two types of exchange rate systems is an important policy debate in international finance.
 - This term describing the extent to which an exchange rate may vary over time is an important consideration in the choice of exchange rate systems.
 - This term describing the likelihood of losing money is an important consideration in the choice of exchange rate systems.
 - Fixed exchange rates are sometimes chosen to mitigate this kind of general price problem.
 - This term describing the ability to influence the economy through monetary policy is an important consideration in the choice of exchange rate systems.

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