

15.5: Which Is Better- Fixed or Floating Exchange Rates?

Learning Objective

1. Learn the pros and cons of both floating and fixed exchange rate systems.

The exchange rate is one of the key international aggregate variables studied in an international finance course. It follows that the choice of exchange rate system is one of the key policy questions.

Countries have been experimenting with different international payment and exchange systems for a very long time. In early history, all trade was barter exchange, meaning goods were traded for other goods. Eventually, especially scarce or precious commodities, for example gold and silver, were used as a medium of exchange and a method for storing value. This practice evolved into the metal standards that prevailed in the nineteenth and early twentieth centuries. By default, since gold and silver standards imply fixed exchange rates between countries, early experience with international monetary systems was exclusively with fixed systems. Fifty years ago, international textbooks dealt almost entirely with international adjustments under a fixed exchange rate system since the world had had few experiences with floating rates.

That experience changed dramatically in 1973 with the collapse of the Bretton Woods fixed exchange rate system. At that time, most of the major developed economies allowed their currencies to float freely, with exchange values being determined in a private market based on supply and demand, rather than by government decree. Although when Bretton Woods collapsed, the participating countries intended to resurrect a new improved system of fixed exchange rates, this never materialized. Instead, countries embarked on a series of experiments with different types of fixed and floating systems.

For example, the European Economic Community (now the EU) implemented the exchange rate mechanism in 1979, which fixed each other's currencies within an agreed band. These currencies continued to float with non-EU countries. By 2000, some of these countries in the EU created a single currency, the euro, which replaced the national currencies and effectively fixed the currencies to each other immutably.

Some countries have fixed their currencies to a major trading partner, and others fix theirs to a basket of currencies comprising several major trading partners. Some have implemented a crawling peg, adjusting the exchange values regularly. Others have implemented a dirty float where the currency value is mostly determined by the market but periodically the central bank intervenes to push the currency value up or down depending on the circumstances. Lastly, some countries, like the United States, have allowed an almost pure float with central bank interventions only on rare occasions.

Unfortunately, the results of these many experiments are mixed. Sometimes floating exchange rate systems have operated flawlessly. At other times, floating rates have changed at breakneck speed, leaving traders, investors, and governments scrambling to adjust to the volatility. Similarly, fixed rates have at times been a salvation to a country, helping to reduce persistent inflation. At other times, countries with fixed exchange rates have been forced to import excessive inflation from the reserve country.

No one system has operated flawlessly in all circumstances. Hence, the best we can do is to highlight the pros and cons of each system and recommend that countries adopt that system that best suits its circumstances.

Probably the best reason to adopt a fixed exchange rate system is to commit to a loss in monetary autonomy. This is necessary whenever a central bank has been independently unable to maintain prudent monetary policy, leading to a reasonably low inflation rate. In other words, when inflation cannot be controlled, adopting a fixed exchange rate system will tie the hands of the central bank and help force a reduction in inflation. Of course, in order for this to work, the country must credibly commit to that fixed rate and avoid pressures that lead to devaluations. Several methods to increase the credibility include the use of currency boards and complete adoption of the other country's currency (i.e., dollarization or euroization). For many countries, for at least a period, fixed exchange rates have helped enormously to reduce inflationary pressures.

Nonetheless, even when countries commit with credible systems in place, pressures on the system sometimes can lead to collapse. Argentina, for example, dismantled its currency board after ten years of operation and reverted to floating rates. In Europe, economic pressures have led to some "talk" about giving up the euro and returning to national currencies. The Bretton Woods system lasted for almost thirty years but eventually collapsed. Thus it has been difficult to maintain a credible fixed exchange rate system for a long period.

Floating exchange rate systems have had a similar colored past. Usually, floating rates are adopted when a fixed system collapses. At the time of a collapse, no one really knows what the market equilibrium exchange rate should be, and it makes some sense to let

market forces (i.e., supply and demand) determine the equilibrium rate. One of the key advantages of floating rates is the autonomy over monetary policy that it affords a country's central bank. When used wisely, monetary policy discretion can provide a useful mechanism for guiding a national economy. A central bank can inject money into the system when the economic growth slows or falls, or it can reduce money when excessively rapid growth leads to inflationary tendencies. Since monetary policy acts much more rapidly than fiscal policy, it is a much quicker policy lever to use to help control the economy.

Prudent Monetary and Fiscal Policies

Interestingly, monetary autonomy is both a negative trait for countries choosing fixed rates to rid themselves of inflation and a positive trait for countries wishing have more control over their domestic economies. It turns out that the key to success in both fixed and floating rates hinges on prudent monetary and fiscal policies. Fixed rates are chosen to force a more prudent monetary policy, while floating rates are a blessing for those countries that already have a prudent monetary policy.

A prudent monetary policy is most likely to arise when two conditions are satisfied. First, the central bank, and the decisions it makes, must be independent of the national government that makes government-spending decisions. If it is not, governments have always been inclined to print money to finance government-spending projects. This has been the primary source of high inflation in most countries. The second condition is a clear guideline for the central bank's objective. Ideally, that guideline should broadly convey a sense that monetary policy will satisfy the demands of a growing economy while maintaining sufficiently low inflation. When these conditions are satisfied, autonomy for a central bank and floating exchange rates will function well. Mandating fixed exchange rates can also work well, but only if the system can be maintained and if the country to which the other country fixes its currency has a prudent monetary policy.

Both systems can experience great difficulties if prudent fiscal policies are not maintained. This requires governments to maintain a balanced budget over time. Balance over time does not mean balance in every period but rather that periodic budget deficits should be offset with periodic budget surpluses. In this way, government debt is managed and does not become excessive. It is also critical that governments do not overextend themselves in terms of international borrowing. International debt problems have become the bane of many countries.

Unfortunately, most countries have been unable to accomplish this objective. Excessive government deficits and borrowing are the norm for both developing and developed countries. When excessive borrowing needs are coupled with a lack of central bank independence, tendencies to hyperinflations and exchange rate volatility are common. When excessive borrowing is coupled with an independent central bank and a floating exchange rate, exchange rate volatility is also common.

Stability of the international payments system then is less related to the type of exchange rate system chosen than it is to the internal policies of the individual countries. Prudent fiscal and monetary policies are the keys.

With prudent domestic policies in place, a floating exchange rate system will operate flawlessly. Fixed exchange systems are most appropriate when a country needs to force itself to a more prudent monetary policy course.

Key Takeaways

- Historically, no one system has operated flawlessly in all circumstances.
- Probably the best reason to adopt a fixed exchange rate system is whenever a central bank has been independently unable to maintain prudent monetary policy, leading to a reasonably low inflation rate.
- Probably the best reason to adopt a floating exchange rate system is whenever a country has more faith in the ability of its own central bank to maintain prudent monetary policy than any other country's ability.
- The key to success in both fixed and floating rates hinges on prudent monetary and fiscal policies. Fixed rates are chosen to force a more prudent monetary policy; floating rates are a blessing for those countries that already have a prudent monetary policy.

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?"
 - Of *fixed* or *floating*, this system is often chosen by countries that in their recent history experienced very high inflation.
 - Of *fixed* or *floating*, this system is typically chosen when a country has confidence in its own ability to conduct monetary policy effectively.

- Of *fixed* or *floating*, this system is typically chosen when a country has little confidence in its own ability to conduct monetary policy effectively.
- Of *fixed* or *floating*, this system is sometimes rejected because it involves the loss of national monetary autonomy.
- Of *fixed* or *floating*, this system is sometimes chosen because it involves the loss of national monetary autonomy.

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