**EXCHANGE RATE SYSTEMS**

Exchange rate systems can be classified according to the degree by which exchange rates are controlled by the government. Exchange rate systems normally fall into one of the following categories:

• Fixed

• Freely floating

• Managed float

• Pegged

Each of these exchange rate systems is discussed in turn.

***Fixed Exchange Rate System***

In a **fixed exchange rate system,** exchange rates are either held constant or allowed to fluctuate only within very narrow boundaries. A fixed exchange rate would be beneficial to a country for the following reasons. First, exporters and importers could engage in international trade without concern about exchange rate movements of the currency to which their local currency is linked. Any firms that accept the foreign currency as payment would be insulated from the risk that the currency could depreciate over time. In addition, any firms that need to obtain that foreign currency in the future would be insulated from the risk of the currency appreciating over time. Another benefit is that firms could engage in direct foreign investment, without concern about exchange rate movements of that currency. They would be able to convert their foreign currency earnings into their home currency without concern that the foreign currency denominating their earnings might weaken over time. Thus, the management of an MNC would be much easier. In addition, investors would be able to invest funds in foreign countries, without concern that the foreign currency denominating their investments might weaken over time. A country with a stable exchange rate can attract more funds as investments because the investors would not have to worry about the currency weakening over time. Funds are needed in any country to support economic growth. Countries that attract a large amount of capital flows normally have lower interest rates. This can stimulate their economies.

If an exchange rate begins to move too much, governments intervene to maintain it within the boundaries. In some situations, a government will **devalue** or reduce the value of its currency against other currencies. In other situations, it will **revalue** or increase the value of its currency against other currencies. A central bank’s actions to devalue a currency in a fixed exchange rate system is referred to as **devaluation.** The term *devaluation* is normally used in a different context than depreciation. Devaluation refers to a downward adjustment of the exchange rate by the central bank. Conversely, **revalution** refers to an upward adjustment of the exchange rate by the central bank.

***Advantages of Fixed Exchange Rates*** to MNCs. In a fi xed exchange rate environment, MNCs may be able to engage in international trade, direct foreign investment, and international finance without worrying about the future exchange rate. Consequently, the managerial duties of an MNC are less difficult.

***Disadvantages of Fixed Exchange Rates to MNCs.*** One disadvantage of a fixed exchange rate system is that there is still risk that the government will alter the value of a specific currency. Although an MNC is not exposed to continual movements in an exchange rate, it does face the possibility that its government will devalue or revalue its currency.

Freely Floating Exchange Rate System

In a **freely floating exchange rate system,** exchange rate values are determined by market forces without intervention by governments. Whereas a fixed exchange rate system allows no flexibility for exchange rate movements, a freely floating exchange rate system allows complete flexibility. A freely floating exchange rate adjusts on a continual basis in response to demand and supply conditions for that currency.

Advantages of a Freely Floating Exchange Rate System.

One advantage of a freely floating exchange rate system is that a country is more insulated from the inflation of other countries.

An additional advantage of a freely floating exchange rate system is that a central bank is not required to constantly maintain exchange rates within specified boundaries. Therefore, it is not forced to implement an intervention policy that may have an unfavorable effect on the economy just to control exchange rates. Furthermore, governments can implement policies without concern as to whether the policies will maintain the exchange rates within specified boundaries. Finally, if exchange rates were not allowed to fl oat, investors would invest funds in whatever country had the highest interest rate. This would likely cause governments in countries with low interest rates to restrict investors’ funds from leaving the country. Thus, there would be more restrictions on capital flows, and financial market efficiency would be reduced.

. Managed Float Exchange Rate System

The exchange rate system that exists today for some currencies lies somewhere between fixed and freely floating. It resembles the freely floating system in that exchange rates are allowed to fluctuate on a daily basis and there are no official boundaries. It is similar to the fixed rate system in that governments can and sometimes do intervene to prevent their currencies from moving too far in a certain direction. This type of system is known as a **managed fl oat** or “dirty” fl oat (as opposed to a “clean” float where rates float freely without government intervention). .

Criticism of a Managed Float System. Critics suggest that a managed float system allows a government to manipulate exchange rates in a manner that can benefit its own country at the expense of others. For example, a government may attempt to weaken its currency to stimulate a stagnant economy. The increased aggregate demand for products that results from such a policy may reflect a decreased aggregate demand for products in other countries, as the weakened currency attracts foreign demand. Although this criticism is valid, it could apply as well to the fixed exchange rate system, where governments have the power to devalue their currencies.

Pegged Exchange Rate System

Some countries use a **pegged exchange rate** arrangement, in which their home currency’s value is pegged to a foreign currency or to some unit of account. While the home currency’s value is fixed in terms of the foreign currency (or unit of account) to which it is pegged, it moves in line with that currency against other currencies.

Some governments peg their currency’s value to that of a stable currency, such as the dollar, because that forces the value of their currency to be stable. First, this forces their currency’s exchange rate with the dollar to be fixed. Second, their currency will move against non-dollar currencies by the same degree as the dollar. Since the dollar is more stable than most currencies, it will make their currency more stable than most currencies. their funds to dollars or some other currency if they fear that the peg may be broken.

They can exchange their currency for dollars to invest in the United States before the peg breaks. They may leave their investment in the United States until after the peg breaks, and their local currency’s value is reduced. Then they can sell their investments in the United States and convert the dollar proceeds back to their currency at a more favorable exchange rate. Their initial actions to convert their money into dollars placed more downward pressure on the local currency. For the reasons explained here, countries have difficulty maintaining a pegged exchange rate when they are experiencing major political or economic problems.

While a country with a stable exchange rate can attract foreign investment, the investors will move their funds to another country if there are concerns that the peg will break. Thus, a pegged exchange rate system could ultimately create more instability in a country’s economy.

Limitations of a Pegged Exchange Rate. While countries with a pegged exchange rate may attract foreign investment because the exchange rate is expected to remain stable, weak economic or political conditions can cause firms and investors to question whether the peg will hold. For example, if the country suddenly experiences a recession, it may experience capital outflows as some firms and investors withdraw funds because they believe there are better investment opportunities in other countries. These transactions result in an exchange of the local currency for dollars and other currencies, which places downward pressure on the local currency’s value. The central bank would need to offset this by intervening in the foreign exchange market but might not be able to maintain the peg. If the peg is broken and the exchange rate is dictated by market forces, the local currency’s value could decline immediately by 20 percent or more. If foreign investors fear that a peg may be broken, they quickly sell their investments in that country and convert the proceeds into their home currency. These transactions place more downward pressure on the local currency of that country. Even the local residents may consider selling their local investments and converting