

Analytical report



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Analytical report (pursuing a floating exchange rate system) Analytical report (pursuing a floating exchange rate system) Introduction

A floating exchange rate system refers to a certain kind of exchange rate arrangement in which the local currency is usually let to rise and fall according to the behavior of the foreign currency exchange market. A floating currency is the type of currency that uses this system. Numerous successful countries pursue the use of this currency including the United Kingdom during the period of an economic crisis. The paper analytically discusses the recommendations of pursuing a floating exchange rate system for a small country.

Discussion

As defined earlier, a floating exchange rate system is a financial system that allows the local currency to fluctuate according to the currency that it is trading with. Numerous countries in the world do not use the floating exchange rate system due to its fluctuating nature. However, in this situation, it would be best for the small country to use this system since it has more positives than negatives when it comes to growth. The recommendations in favor of this system and some of its disadvantages are discussed below.

Advantages of a floating exchange rate system

One of the main advantages of this type of system is the fact that there is an automatic balance of payment adjustments. This means that if there is disequilibrium in the balance of payments, it is normally be corrected by changes in the exchange rate system. This means that if a country has disequilibrium in the balance of payment, then it means that the currency would have to decrease in value. First of all the disequilibrium is brought

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forth by the fact that the exports outweigh the imports in terms of supply. Therefore, the local currency would be greatly supplied in the foreign market (Bized, 2011, para. 4). This would drive the value of the local currency down and would mean that the imports would be made more expensive and the exports cheaper. This would lead to an automatic increase in demand for the exports which would ultimately result to a balance of payment adjustment. The other main advantage of this type of system is that it frees the internal policy. This means that the balance of payment is usually rectified when there is disequilibrium by a change in the external price of the local currency. This is as opposed to a fixed exchange rate system in which if there is disequilibrium it means that there is the need to cause a general deflationary. This deflationary could result to the general unemployment of the citizenry. The other main advantage of this type of system is that the country would be free from economic crisis but not completely as money is usually unpredictable. This is because when pursuing a fixed rate, there is usually a lot of issues such as devaluing and revaluing of the currency but with the floating system, such changes are usually automatic. The final great advantage that this type of system has is that the currency of the small country would be flexible. This can be summarized by the global OPEC oil shock that occurred in 1973 and led to the major problems to countries that pursued the fixed exchange rate system as they became uncompetitive due to the inflation rates that they faced as opposed to a floating system that had internal flexibility against external shocks.

Disadvantages a floating exchange rate system

Just like any other financial exchange rate system, the floating exchange rate arrangement has some disadvantages. The first one is that there is

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always uncertainty about the local currency. This is because the global currency always changes day in day out and this would mean that this type of setting would lead to uncertainty in terms of the sellers as they would not be sure of the total amount of money they may receive for a good in a day or the other. In addition to that, this system is also prone to lack of investments as the locals and international investors would be lax due to the fact that they may not know the way the local currency may tend to behave the next day (Bized, 2011, para. 8). This therefore, would lead to the overall fall of the currency and an overall, the fall of the country's economy. In the real sense, these are the only true threats that this type of system faces.

Conclusion

In conclusion, pursuing the floating exchange rate system is a good decision since the economic advantages outweigh the disadvantages. This type of economic setting would be very essential in ensuring that the whole country and its citizens benefits from the way the international currency behaves and that is why it would be advisable for a growing economy to pursue it.

Reference

Bized. (2011, February 06). Further work - The advantages and disadvantages of floating exchange rates. Retrieved March 14, 2012, from Bized: <http://www.bized.co.uk/virtual/bank/economics/markets/foreign/further2.htm>