Floating and fixed exchange rates

Why are floating rates considered to be superior to fixed rates in dealing with major shocks such as oil price increases? Explain why floating exchange rates did not produce a reduction in the US balance of payments deficit during the early 1980s? Describe the system that was developed to replace floating exchange rates. First we need to explain what fixed and floating exchange rates are. Fixed exchange rate regime is a regime in which central banks buy and sell their own currencies to keep their exchange rates fixed at a certain level (Mishkin G-4).

Floating exchange rate regime is an exchange rate regime in which the value of currencies are allowed to fluctuate against one another (Mishkin G-5). Floating exchange rates are like a shock absorber. When export demand declines, depreciation makes domestic goods more competitive abroad, stimulates an offsetting expansion in demand, and dampens the contraction in domestic economic activity (FRBSF). For a short-term floating rates would be good during a shock such as oil price increases, but not for long-term.

During this short-term, floating rates influence economic activity. With a fixed exchange rate, economic activity adjusts to the exchange rate, where with a floating rate the exchange rate is a reflection of economic activity. Both fixed and float exchange rates have strengths and weaknesses. Floating exchange rates did not produce reduction in the US balance of payment deficit during the early 1980s because influential economic arguments supported fixed exchange rate regimes as an anchor to break hyper- and high inflation in many emerging markets (Treasury).

Because foreign exchange crises lead to large changes in central banks’ holdings of international reserved and thus significantly affect the official reserve asset items in the balance of payment. The system that was developed to replace floating exchange rates was Dirty Float. Dirty Float is a system where countries attempt to influence their exchange rates by buying and selling currencies (Mishkin G-3). It’s meant as a buffer against an external economic shock before its effects become truly disruptive to the economy (Investopedia).

In conclusion, floating rates can be superior to fixed rates during major shocks. As the Treasury states: It became clear that economies operating in the framework of a flexible exchange rate system were better able to absorb shocks from open capital markets than economies with a pegged rate (Treasury). Works Cited FRBSF. To Float or Not to Float? Exchange Rate Regimes and Shocks. Federal Reserve Bank of San Francicsco. Publication 2005-01. 7 January 2005. Web. 8 December 2011. http://www. frbsf. org/publications/economics/letter/2005/el2005-01. pdf. Investopedia. http://www. investopedia. com/terms/d/dirtyfloat. asp#ixzz1gvegntCo Mishkin, Frederic S. The Economics of Money, Banking & Financial Markets. Columbia University. 2010. Treasury. “ Fixed vs. Flexible Exchange Rates. ” Treasury. gov. Web. 18 December 2011. http://www. treasury. gov/resource-center/international/exchange-rate-policies/Documents/Appendix_2. pdf