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# The three major types of exchange rate systems are the float, the fixed rate, and the pegged float.

LEARNING OBJECTIVE [ edit ]

- Differentiate common exchange rate systems

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KEY POINTS [ edit ]

- A floating exchange rate or fluctuating exchange rate is a type of exchange rate regime wherein a currency's value is allowed to freely fluctuate according to the foreign exchange market.
- A fixed exchange-rate system (also known as pegged exchange rate system) is a currency system in which governments try to maintain their currency value constant against a specific currency or good.
- Pegged floating currencies are pegged to some band or value, either fixed or periodically adjusted. These are a hybrid of fixed and floating regimes.

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TERMS [ edit ]

- pegged float exchange rate

  A currency system that fixes an exchange rate around a certain value, but still allows fluctuations, usually within certain values, to occur.

- fixed exchange rate

  A system where a currency's value is tied to the value of another single currency, to a basket of other currencies, or to another measure of value, such as gold.

- floating exchange rate

  A system where the value of currency in relation to others is allowed to freely fluctuate subject to market forces.

- exchange rate regime

  The way in which an authority manages its currency in relation to other currencies and the foreign exchange market.

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EXAMPLE [ edit ]

- Examples of floating currencies include the US dollar, the European Union euro, the Japanese yen, and the British pound. Examples of fixed currencies include the Hong Kong dollar, the Danish krone, and the Bermudian dollar.

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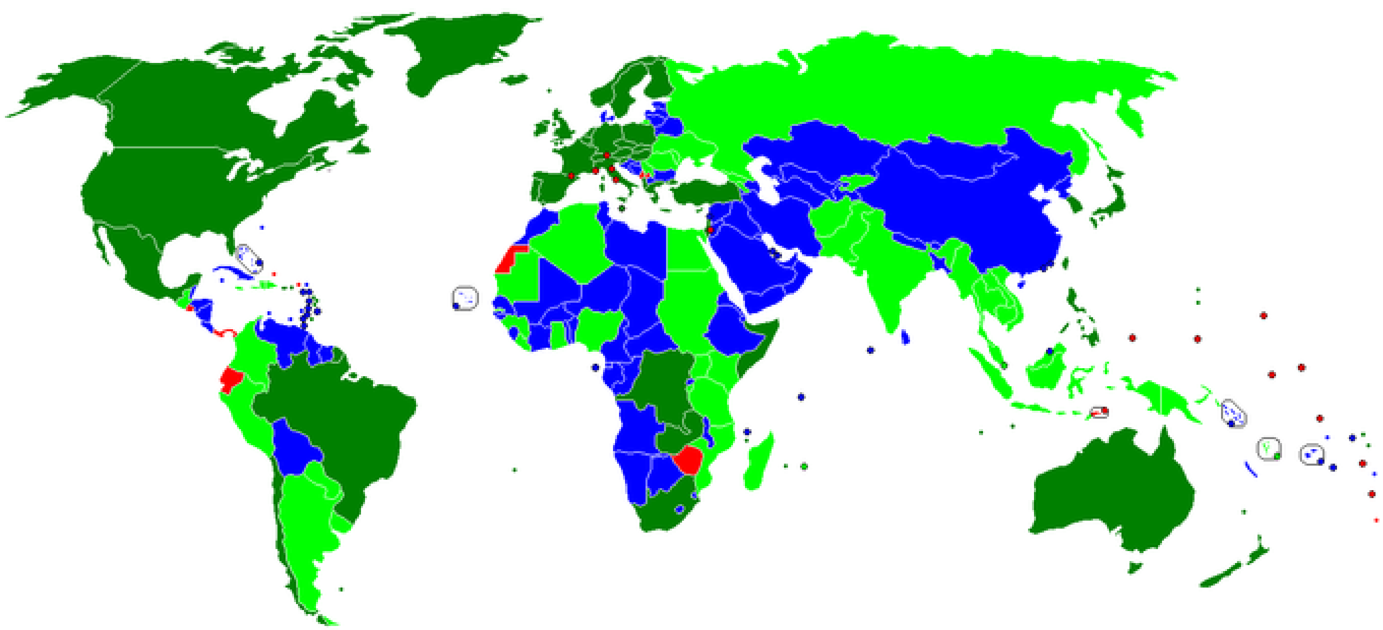
FULL TEXT [ edit ]

One of the key economic decisions a nation must make is how it will value its currency in comparison to other currencies. An exchange rate regime is how a nation manages its currency in the foreign exchange market. An exchange rate regime is closely related to that country's monetary policy. There are three basic types of exchange regimes: floating exchange, fixed exchange, and pegged float exchange .





Foreign Exchange Regimes

*The above map shows which countries have adopted which exchange rate regime. Dark green is for free float, neon green is for managed float, blue is for currency peg, and red is for countries that use another* *country's currency.*

## The Floating Exchange Rate

A floating exchange rate, or fluctuating exchange rate, is a type of exchange rate regime wherein a currency's value is allowed to fluctuate according to the foreign exchange market. A currency that uses a floating exchange rate is known as a floating currency. The dollar is an example of a floating currency.

Many economists believe floating exchange rates are the best possible exchange rate regime because these regimes automatically adjust to economic circumstances. These regimes enable a country to dampen the impact of shocks and foreign business cycles, and to preempt the possibility of having a balance of payments crisis. However, they also engender unpredictability as the result of their dynamism.

## The Fixed Exchange Rate

A fixed exchange rate system, or pegged exchange rate system, is a currency system in which governments try to maintain a currency value that is constant against a specific currency or good. In a fixed exchange-rate system, a country's government decides the worth of its currency in terms of either a fixed weight of an asset, another currency, or a basket of other currencies. The central bank of a country remains committed at all times to buy and sell its currency at a fixed price.

To ensure that a currency will maintain its "pegged" value, the country's central bank maintain reserves of foreign currencies and gold. They can sell these reserves in order to intervene in the foreign exchange market to make up excess demand or take up excess supply of the country's currency.

The most famous fixed rate system is the gold standard, where a unit of currency is pegged to a specific measure of gold. Regimes also peg to other currencies. These countries can either choose a single currency to peg to, or a "basket" consisting of the currencies of the country's major trading partners.

## The Pegged Float Exchange Rate

Pegged floating currencies are pegged to some band or value, which is either fixed or periodically adjusted. These are a hybrid of fixed and floating regimes. There are three types of pegged float regimes:

- Crawling bands: The market value of a national currency is permitted to fluctuate within a range specified by a band of fluctuation. This band is determined by international agreements or by unilateral decision by a central bank. The bands are adjusted periodically by the country's central bank. Generally the bands are adjusted in response to economic circumstances and indicators.

- Crawling pegs:A crawling peg is an exchange rate regime, usually seen as a part of fixed exchange rate regimes, that allows gradual depreciation or appreciation in an exchange rate. The system is a method to fully utilize the peg under the fixed exchange regimes, as well as the flexibility under the floating exchange rate regime. The system is designed to peg at a certain value but, at the same time, to "glide" in response to external market uncertainties. In dealing with external pressure to appreciate or depreciate the exchange rate (such as interest rate differentials or changes in foreign exchange reserves), the system can meet frequent but moderate exchange rate changes to ensure that the economic dislocation is minimized.
- Pegged with horizontal bands:This system is similar to crawling bands, but the currency is allowed to fluctuate within a larger band of greater than one percent of the currency's value.



PREV CONCEPT

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Referenced in **1 quiz question**

A country allows its currency to freely fluctuate according to the foreign exchange market. What type of exchange regime does this country have?

A fixed exchange rate regime, A floating exchange regime, A pegged exchange regime, or A pegged floating regime

KEY TERM REFERENCE

**Union** — **Appears in these related concepts:** Quotas, Antitrust Laws, and The Wage Rate

**asset** — **Appears in these related concepts:** Balance Sheets, The Demand for Money, and Shifts in the Money Demand Curve

**balance of payments** — **Appears in these related concepts:** Balance of Payments, The International Monetary Fund (IMF), and The Balance of Payments

**business cycle** — **Appears in these related concepts:** Calculating Economic Growth, Job Creation and Destruction, and Effect of a Government Budget Deficit on Investment and Equilibrium

**central bank** — **Appears in these related concepts:** The Money Multiplier in Theory, Arguments For and Against Inflation Targeting Policy Interventions, and The Financial Account

**currency** — **Appears in these related concepts:** Non-Bank Financial Institutions, Measuring the Money Supply, and Example Transactions Showing How a Bank Can Create Money

**demand** — **Appears in these related concepts:** Monopoly Price and Profit, Macroeconomic Equilibrium, and Shifts in investment due to shocks

**depreciate** — **Appears in these related concepts:** Bernanke Era, Finding an Equilibrium Exchange Rate, and Defining Capital

**depreciation** — **Appears in these related concepts:** Sale, Sample Income Statement, and Other Approaches to Calculating GDP

**differential** — **Appears in these related concepts:** Triple Integrals in Cylindrical Coordinates, Thermal Stresses, and Compensation Differentials

**exchange rate** — **Appears in these related concepts:** Types of Exchange Exposure: Short-Run, Long-Run, and Translation, International Exchange of Money, and Introducing Exchange Rates

**foreign exchange** — **Appears in these related concepts:** The Importance of Aggregate Decisions about Consumption versus Saving and Investment, The Balance of Trade, and Reason for a Zero Balance

**gold standard** — **Appears in these related concepts:** Strengthening the Monetary System, Banking and Finance Reform, and Monetarist

**interest rate** — **Appears in these related concepts:** The Equilibrium Interest Rate, Interest Rates and Economic Rationale, and Determinants of investment

**intervene** — **Appears in these related concepts:** Government Intervention May Fix Inefficient Markets, Why Governments Intervene In Markets, and Introducing Externalities

**monetary policy** — **Appears in these related concepts:** Structure of the Federal Reserve, The Structure and Function of Other Banks, and The Reserve Ratio

**price** — **Appears in these related concepts:** Break-Even Analysis, Terms Used to Describe

Price, and Defining a Market System

**reserve** — **Appears in these related concepts:** Government Action, The Federal Open Market Committee and the Role of the Fed, and The Federal Funds Rate

**reserves** — **Appears in these related concepts:** Other Barriers to Entry, Measuring the Money Supply: M1, and The Fractional Reserve System

**shock** — **Appears in these related concepts:** Nerve and Blood Supply, Fractures of the Vertebral Column, and Homeostatic Responses to Shock

**supply** — **Appears in these related concepts:** Impacts of Supply and Demand on Businesses, Applications of Elasticities, and The Slope of the Short-Run Aggregate Supply Curve

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