EXCHANGE RATE SYSTEMS

An exchange rate is the price of one currency expressed in terms of another. An exchange rate system is the way in which the exchange rate is determined. These come in three types. They are:

1. **Fixed -** this is an exchange rate system where one currency is fixed in value against another. It involves the government working to keep the parity via intervention on the currency markets. These give certainty but can cost vast sums of foreign exchange from national reserves.

2. **Floating** - this is an exchange rate which accepts that market forces will determine rates based on how they view a country's trade performance and its economic and political stability. These systems cost less to maintain but can result in vast swings and changes in currency values. This can seriously affect trade performance and confidence.

3. **Managed or dirty float** - which is where the rate is floating but between upper and lower limits that the domestic government keeps it to. It brings more stability but at less cost to the national reserves.

Floating Exchange Rates

Under a floating rate system, a currency's exchange rate is simply determined by the free market forces of demand and supply, without any intervention by the government or its central bank.

Demand curve of foreign exchange is downward sloping: