Fixed or pegged exchange rate system :

In the case of fixed or pegged exchange system, all the international transactions take place at the rate of exchange fixed by the monetary authority. The exchange rate is either fixed by the government throug legislation or it comes into existence through the intervention in the foreign exchange market by the authorities. If the rate of exchange diverges from the fixed equilibrium level due to market forces or the activities of speculators, the monetary authority or the govt. interferes in the foreign exchange market and maintains the rate of exchange at the equilibrium level. The market intervention in such a situation is called pegging, i.e., the sale or purchase of foreign exchange in the foreign exchange market. It is just like the buffer stocks operation in foreign exchange. The authorities buy the foreign exchange when there is excess supply of it and sell it out when there is excessive demand for it in the exchange market. The pegging operations facilitate the maintenance or 'pegging' of the rate of exchange at the desired equilibrium level.

• Arguments in favour of fixed or stable exchange rates

1. Promotion of international Trade — If the exchange rates are fixed or stable, the prices of internationally traded goods become more stable and predictable. Under this system, the exporters know in advance what they will receive in terms of the domestic currency and importers know how much they will have to pay. Given such a certainity, which does not

exist in a freely fluctuating exchange system, the international trade can definitely expand.

2. <u>International division of labour and specialisation</u>: The system of fixed exchange rates not only promotes international trade but also contributes in raising productivity and absolute output through increased international division of labour and specialisation.

3. <u>Promotion of economic integration</u>: In an economic union, member countries strive to evolve a common currency. That is the necessary requirement for integrating their economic policies. The system of fixed exchange rate is just like a common currency in which the exchange value of the currency remains unchanged in terms of the domestic currency of a particular country. So this system can pave the way for greater degree of economic integration among the countries.

4. <u>Long term capital investments</u>: In case of stable exchange rates, there is little uncertainty and risk. As a consequence, the investors can plan long term international investments. Large scale capital inflows from abroad can facilitate the achievement of a higher rate of growth. The greater the uncertainty and risk under the flexible exchange system, in contrast, is likely to impede the long-term capital flows.

5. <u>No adverse effect of speculation</u>: Since the exchange rate remains stable under the fixed exchange rate system, there is little scope for speculation and the consequent adverse effects. The advocates of fixed exchange system point out that the speculation is

destablishing under the flexible exchange system.

6. Confidence in the strength of currency : This exchange system does not involve appreciation or depreciation of currency. There is no fear of risk or loss due to larger holdings of foreign currency, if the value of currency declines. This imparts greater confidence in the strength of the domestic currency.

- Arguments against fixed exchange rates :

① Primacy to exchange stability :- A serious defect in this system of exchange rates is that the authorities become concerned primarily with the maintenance of exchange rate at some official level. It often results in the sacrifice of the objectives of price stability and full employment.

2. Difficulty in building up of exchange reserves :- Under a fixed exchange system every country is required to build up idle stock of foreign currencies. It necessitates the BOP surplus at least for some years. The LDCs will find it difficult to have BOP surpluses for building up sufficient foreign exchange reserves. It is often beyond their capacity to even offset the persistent BOP deficit.

3. Heavy burden upon the authorities :- If a country is under continuous pressure on account of the BOP deficit, the government or monetary authority may not be in a position to mobilise sufficient international liquid resources for undertaking the pegging operations. In the event of failure to mobilise reserves of foreign currencies, the home currency has to be devalued.

4. Need to build exchange reserves — The necessity of maintaining the exchange rate at an official level, makes the authorities to undertake pegging operations. For this purpose, it is necessary to maintain sufficient reserves of foreign currencies. Unless these reserves are maintained, a country faced with BOP deficit will have to depend upon ~~deva-tuation~~ devaluation.

5. International transmission of economic variation: The fixed or stable exchange rates can be responsible for transmitting the economic disturbances in ~~the~~ one country to another. Suppose there are deflationary conditions in ~~the~~ one country. It will export its low-price goods to other countries. The industries of foreign countries, faced with competition from cheap goods, will be forced to lower their prices. Thus, deflationary conditions get transmitted. Similarly, the inflationary trends in one country will get transmitted to the other countries. In this way, the economic variations, under the fixed exchange ~~sy~~ system, leak out from one country to its trading partners and vice-versa.

6. Exchange controls: The policy of fixed or stable exchange rates requires quite complicated exchange control mechanism. This can result in misallocation of economic resources, ~~beaure~~ bureaucratic inefficiency and corruption.

- **Flexible or fluctuating exchange rate system:**

The flexible or fluctuating exchange rates are determined by the free working of the market forces. If there is an excess demand for foreign currency over its supply, the foreign currency appreciates whereas the ~~to~~ home currency depreciates. On the other hand, when the supply of foreign currency exceeds the demand for it, the foreign currency depreciates and the exchange value of the home currency appreciates in terms of the foreign currency. Thus, there is an ~~are~~ appropriate variations in the exchange rates to maintain the BOP equilibrium. The impact of changes in the demand for and supply of foreign currency upon the rate of exchange and consequent effect on the BOP adjustments can be shown through fig. a and fig. b.

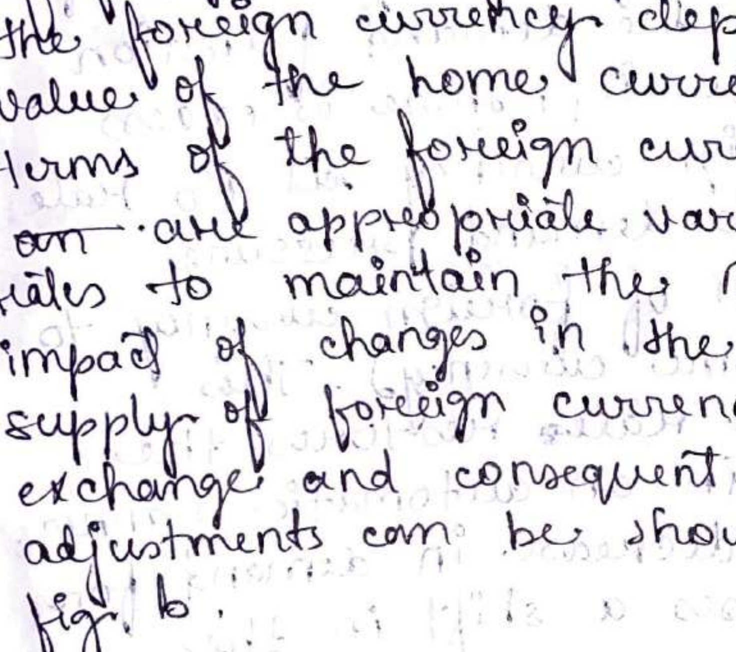

fig (a)

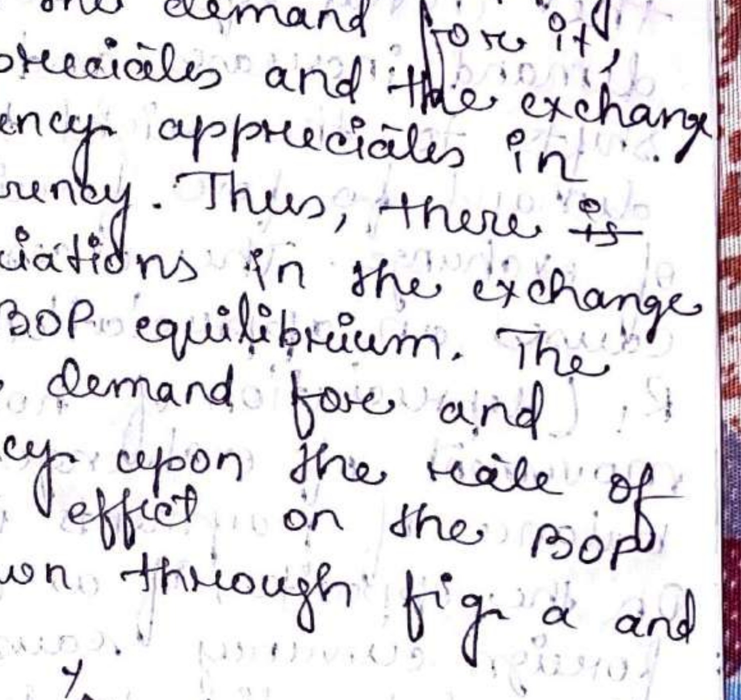

fig (b)

In fig. (a) and (b), the amount of foreign currency is measured along the horizontal scale and the rate of exchange is measured along the vertical scale. In fig (a), given the demand and supply functions of foreign currency D and S, the initial eql^m rate of exchange is R_0. If demand increases and the demand function shifts to the right to D_1; there is excess demand ~~to~~ for foreign currency at R_0 rate of exchange. The excess demand pressure causes an appreciation of foreign currency to R_1 (depreciation of home currency). This movement of exchange rate restores the balance of payments in an automatic manner. On the opposite, if a decrease in demand for foreign currency causes a shift in the demand function to D_2, there is a deficiency of demand for foreign currency at R_0 rate. As a result, the foreign currency depreciates to R_2 (appreciation of home currency). This movement of rate of exchange neutralises any possibility of BOP surplus and keeps the system in a state of balance.

In fig (b), the original eql^m rate of exchange is R_0. If there is an increase in supply of foreign currency, the supply function shifts to the right to S_1 causing a ~~depreciation~~ depreciation in foreign currency at R_1 (appreciation of home currency). On the opposite a decrease in the supply causes a shift in the supply function to the left to S_2. There is shortage of the foreign currency at the original rate. It leads to an appreciation of foreign exchange upto R_2 (or depreciation of home currency).

Whether there is a BOP deficit or surplus, it can be easily and rapidly offset by the free movement of the exchange rates. The monetary or fiscal authorities are not required to intervene to correct the BOP disequilibrium. The market forces of demand and supply operate in an automatic way and no need is felt for making accomodating capital transactions for achieving or maintaining the BOP eqm. The flexible ~~exc~~ exchange rates are also called floating exchange rates.

- <u>Arguments in favour of flexible exchange rates.</u>

1. <u>Simple mechanism</u> – The system of flexible exchange rates operates in an easy, ~~eq~~ quick and efficient ~~way~~ manner in clearing the foreign exchange market. It ensures an automatic adjustment between the forces of demand and supply. The mechanism is simple because it can work efficiently without involving any ~~inter~~ intervention of the monetary ~~policy~~ or fiscal authorities in the foreign exchange market.

2. Continuous adjustments : Under a fixed exchange system, there are periodic crisis and aggravation of balance of payments pressures. It is essential that the corrective actions are taken. The success of these corrective measures is never definite. In contrast, under a ~~fixed~~ system of flexible exchange rates, there are smooth and continuous adjustments in the foreign exchange market through appropriate changes in the rates of exchange.

3. No need of accomodating gold or capital movements : Unlike the fixed exchange system, where the achievment of BOP equilibrium requires the accomodating gold or capital movements, there is no such necessity under flexible exchange rates. The automatic exchange rate of adjustments ensure the maintenance of BOP eqlm even without the accomodating transactions.

4. No necessity of adjustments through price and income changes — In the fixed exchange ~~rate~~ system, the BOP equilibrium may necessitate deliberate resort to deflationary or inflationary policies. The objective may be achieved sometimes also through the income and expenditure poicies. The effect of such policies may be quite widespread in the economy.

5. Economical : The flexible exchange system is very economical. There is no idle holding of international currency reserves that is so essential under the system of ~~fi~~ fixed exchange

rates. The countries having flexible exchange rate system can make an optimum use of their entire available exchange reserves.

6. Beneficial for international trade — There is a wrong impression that the instability of exchange rates will have an adverse effect on the expansion of international trade. On that logic, the fixed exchange rates were supported.

- Arguments against flexible exchange rates —

1. Possibility of disequilibrium : In case of flexible exchange system, it is believed that the free working of the market forces result in the establishment of rate of exchange that corresponds with the BOP eqlm. There is a possibility that the demand and supply forces in the foreign exchange market operate in such a way that the exchange rate diverges farther and farther from the natural level of rate of exchange and the ~~various~~ variations in the rate of exchange fail to bring about the BOP eqlm.

2. Indirect govt. Intervention : The flexible exchange system presumes that the govt. does not interfere in the foreign exchange market. The government may not directly interfere ~~in~~ through pegging or exchange controls & and regulations. But there can still be indirect government intervention through the impact of monetary and fiscal policies.

3. Exchange ~~rates~~ risks and uncertainty : The flexible exchange system causes frequent

variations in the rates of exchange which create exchange risks, breed uncertainty and impede the international trade and capital movements.

4. <u>Inflationary impact of flexible exchange rates</u> :-

Critics of flexible exchange rates put forward a forceful argument that this system has a strong inflationary bias. If there is exchange depreciation, there ~~is~~ can be a rise in the domestic price level. Depreciation of exchange rate makes imports more expensive. As the import prices rise, the use of imported inputs raise the cost of production in a number of home industries. This leads to cost-push inflation in the home country.