

# Fixed and Flexible Exchange rate

# Meaning

- **Fixed exchange** rate system is referred to as the exchange system where the exchange rate is fixed by the government or any monetary authority. It is not determined by the market forces.
- **Flexible exchange** rate system is the exchange system where the exchange rate is dependent upon the supply and demand of money in the market.
- In a flexible exchange rate system, the value of the currency is allowed to fluctuate freely as per the changes in the demand and supply of the foreign exchange. But in Fixed exchange rate system the changes determine by government or any monetary authority.

# Aurgument For Fixed Exchange rate

**Stability and Predictability:** Fixed exchange rates provide stability and predictability for businesses engaged in international trade. Companies can plan and make investment decisions with more confidence when they have a clear understanding of the exchange rate environment.

**Inflation Control:** A fixed exchange rate can help control inflation by limiting the ability of a country's central bank to print excessive amounts of money. This is because maintaining the fixed rate often requires aligning the money supply with the country's foreign exchange reserves.

**Reduced Currency Risk:** Businesses that engage in international trade may face significant risks due to fluctuations in exchange rates. A fixed exchange rate system reduces this currency risk, making it easier for businesses to manage their finances and reduce uncertainty.

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- **Discipline for Monetary Policies:** Fixed exchange rates can act as a discipline for governments to adopt discreet fiscal and monetary policies. In order to maintain the fixed rate, countries may be more inclined to pursue responsible economic policies to avoid speculative attacks on their currency.
- **Promotion of Trade:** A stable exchange rate can promote international trade by providing a reliable and consistent pricing mechanism for goods and services. This stability makes it easier for businesses to engage in cross-border transactions without the fear of sudden and unpredictable changes in exchange rates.
- **Encourages Foreign Investment:** Fixed exchange rates can attract foreign investors by reducing the uncertainty associated with currency fluctuations. Investors may be more willing to commit capital to a country with a stable exchange rate, as it minimizes the risk of currency depreciation eroding the value of their investments.

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- **Simplicity and Transparency:** Fixed exchange rate systems are often simpler to understand and implement compared to floating exchange rate systems. This simplicity can make it easier for policymakers, businesses, and the general public to grasp the dynamics of the monetary system.
- **Prevents Competitive Devaluation:** In a fixed exchange rate system, countries are less likely to engage in competitive devaluation (deliberately lowering the value of their currency to gain a trade advantage). This can help maintain a level playing field in international trade.

# Aurgument Against Fixed Exchange rate

**Loss of Monetary Policy Independence:** Countries with fixed exchange rates often have to give up some degree of control over their monetary policy. To maintain the fixed rate, the central bank may need to adjust interest rates and money supply to align with the policies of the currency to which it is pegged. This can limit a country's ability to use monetary tools to address domestic economic challenges.

**Inability to Respond to Economic Shocks:** Fixed exchange rate regimes may make it challenging for countries to respond effectively to economic shocks. In a flexible exchange rate system, a country can adjust its currency value in response to changing economic conditions. With a fixed rate, adjustments are constrained, potentially leading to imbalances and economic downturns.

**Speculative Attacks:** Fixed exchange rates can be vulnerable to speculative attacks. If traders believe that a country's currency is overvalued, they may engage in speculative activities to force a devaluation, leading to a currency crisis. Countries may need to use significant foreign exchange reserves to defend their fixed exchange rates.

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- **Lack of Automatic Adjustment:** Unlike floating exchange rates that automatically adjust based on market forces, fixed exchange rates require active intervention by the central bank. This can lead to prolonged periods of misalignment between the exchange rate and economic fundamentals, causing inefficiencies in resource allocation.
- **Trade Imbalances:** Fixed exchange rates may contribute to persistent trade imbalances. Countries with undervalued currencies may run persistent trade surpluses, while countries with overvalued currencies may face trade deficits. This imbalance can lead to long-term economic distortions.
- **Rigidity in the System:** Fixed exchange rates can be too rigid for dynamic and rapidly changing economies. Economic conditions may evolve, and fixed rates may not allow for the necessary adjustments to maintain competitiveness and sustainable growth.

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- **Coordination Challenges:** In a system where multiple countries are pegged to the same currency (e.g., a gold standard or a common currency like the Euro), coordination becomes crucial. If one country pursues policies that are inconsistent with the fixed exchange rate arrangement, it can create tensions and imbalances in the entire system.
- **Difficulty in Choosing an Appropriate Peg:** Selecting an appropriate currency or basket of currencies to peg to can be challenging. The chosen currency might not align with the economic conditions or goals of the country adopting the fixed exchange rate, leading to difficulties in maintaining stability.



# Argument For Flexible Exchange rate

- **Automatic Adjustment to Economic Shocks:** Flexible exchange rates allow currencies to adjust automatically to changes in economic conditions. In the face of economic shocks such as changes in interest rates, inflation, or trade imbalances, the exchange rate can act as a shock absorber, helping to restore equilibrium in the economy.
- **Monetary Policy Independence:** Countries with flexible exchange rates have greater control over their domestic monetary policy. Central banks can set interest rates and adjust money supply to address domestic economic goals without being constrained by the need to maintain a fixed exchange rate.
- **Market-Driven Efficiency:** Flexible exchange rates are determined by supply and demand in the foreign exchange market. This market-driven mechanism ensures that the currency's value reflects the underlying economic fundamentals, promoting efficiency in the allocation of resources and capital.

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- **Reduced Speculative Attacks:** Unlike fixed exchange rates, where speculative attacks can be a concern, flexible exchange rates provide a natural defense against speculative pressures. Market forces tend to correct misalignments in currency values, reducing the likelihood of sustained speculative attacks.
- **Trade Balance Adjustment:** Flexible exchange rates can facilitate adjustments in a country's trade balance. If a country is running a trade deficit, a depreciating currency can make its exports more competitive, potentially improving the trade balance over time.
- **Flexibility in Economic Policies:** Flexible exchange rates allow countries to pursue independent economic policies tailored to their specific circumstances. This flexibility is particularly important in responding to domestic economic challenges and global economic trends.

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- **Encourages Economic Reforms:** Knowing that the exchange rate can adjust based on economic conditions, countries may be motivated to implement structural reforms to enhance competitiveness. This can lead to increased productivity, innovation, and long-term economic growth.
- **Adaptability to External Shocks:** Countries with flexible exchange rates are better positioned to adapt to external shocks, such as changes in global commodity prices or economic downturns in major trading partners. The exchange rate can absorb some of the impact, helping the economy adjust more smoothly.
- **Market Signals for Investors:** Flexible exchange rates provide important signals to international investors about a country's economic conditions and policies. This transparency can influence investment decisions and contribute to a more efficient allocation of capital.

# Argument Against Flexible Exchange rate

- **Exchange Rate Volatility:** One of the primary criticisms of flexible exchange rates is the potential for increased volatility. Exchange rates can experience significant fluctuations in response to market sentiment, speculative activities, or sudden economic events. This volatility can create uncertainty for businesses engaged in international trade and investment.
- **Speculative Attacks and Herd Behavior:** Flexible exchange rates are susceptible to speculative attacks and herd behavior in the foreign exchange market. Traders may sometimes engage in speculative activities based on expectations rather than economic fundamentals, leading to exaggerated and destabilizing movements in exchange rates.
- **Impact on Trade and Investment Planning:** The uncertainty associated with fluctuating exchange rates can make it challenging for businesses to plan and invest with confidence. Companies may be hesitant to engage in long-term projects or make significant investments if they cannot predict future currency values.

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- **Trade Distortions:** While flexible exchange rates can help adjust trade imbalances, they may also lead to persistent trade distortions. Countries with more volatile currencies may face challenges in maintaining competitiveness, and this can contribute to trade imbalances and economic inefficiencies.
- **Inflationary Pressures:** Frequent and large fluctuations in exchange rates can contribute to inflationary pressures. Sudden currency depreciations may lead to higher import prices, impacting the cost of living and eroding the purchasing power of consumers.
- **Lack of Discipline in Economic Policies:** Critics argue that flexible exchange rates may lead to a lack of discipline in economic policies. Policymakers may be tempted to pursue short-term measures without considering the long-term consequences, relying on exchange rate adjustments to offset the impact.

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- **Coordination Issues:** In a world with multiple currencies and varying exchange rate policies, the lack of coordination can lead to currency wars and heightened global economic uncertainty. Uncoordinated monetary policies may result in unintended consequences for international trade and capital flows.
- **Financial Market Instability:** Volatile exchange rates can contribute to instability in financial markets. Sudden and large currency movements may impact financial institutions, leading to concerns about systemic risks and the stability of the financial system.
- **Currency Manipulation:** Some argue that flexible exchange rates create opportunities for countries to engage in currency manipulation for trade advantage. Countries may intentionally devalue their currencies to boost exports, potentially leading to tensions and trade disputes.

# Difference Between Fixed and Flexible Exchange Rate

Type	Fixed Rate	Flexible Exchange Rate
Definition	Fixed rate is the system where the government decides the exchange rate	Flexible exchange rate is the system which is dependent on the demand and supply of the currency in the market
Deciding authority	Fixed rate is determined by the central government	Flexible rate is determined by demand and supply forces
Impact on Currency	Currency is devalued and if any changes take place in the currency, it is revalued.	Currency appreciates and depreciates in a flexible exchange rate
Involvement of Government Bank	Government bank determines the rate of exchange	No such involvement of government bank
Need for maintaining foreign reserve	Foreign reserves need to be maintained	No need for maintaining foreign reserve
Impact on BOP (Balance of Payment)	Can cause deficit in BOP that cannot be adjusted	Deficit or surplus in BOP is automatically corrected

# Foreign Exchange Regulation Act (FERA)



# Background & Meaning

- The Foreign Exchange Regulation Act (FERA) was an important piece of legislation in India that aimed to regulate foreign exchange and foreign trade in the country.
- It was enacted in 1973, replacing the earlier Foreign Exchange Regulation Act of 1947.
- FERA was later repealed in 1999 and replaced by the Foreign Exchange Management Act (FEMA).

**Objective:** The primary objective of FERA was to regulate and control certain aspects of foreign exchange and foreign trade in India. It sought to conserve foreign exchange resources and ensure that they were used efficiently for the economic development of the country.

# Key Features

- **Control and Regulation:** FERA granted significant powers to the government to control and regulate foreign exchange transactions. It empowered the Reserve Bank of India (RBI) and the government to oversee foreign exchange reserves, approve transactions, and license foreign exchange dealers.
- **Restrictions on Transactions:** FERA imposed restrictions on various foreign exchange transactions, including the acquisition and holding of foreign exchange, payments outside India, and transactions involving foreign securities.
- **Authorized Dealers:** FERA required individuals and entities to conduct foreign exchange transactions through authorized dealers, typically authorized banks. This helped in centralizing and monitoring foreign exchange transactions.

# Key Features

- **Penalties and Enforcement:** FERA had strict provisions for penalties and enforcement. Violations of the act could lead to severe penalties, including fines and imprisonment. Enforcement authorities had the power to investigate and take action against individuals or entities suspected of violating the provisions of the act.
- **Control over Foreign Investments:** FERA played a significant role in controlling foreign investments in India. It regulated the inflow and outflow of foreign capital and required government approval for certain types of foreign investments.
- **Amendments:** FERA underwent several amendments during its existence to adapt to changing economic conditions. However, over time, it became clear that a more liberalized and open economic policy was necessary to encourage foreign investment and boost economic growth.

# Foreign Exchange Management Act (FEMA)

# Background & Meaning

- The Foreign Exchange Management Act (FEMA) is a legislation enacted in India in 1999 to replace the Foreign Exchange Regulation Act (FERA) of 1973.
- FEMA was introduced as part of the broader economic reforms undertaken by India to liberalize its economy and integrate with the global markets.
- The primary purpose of FEMA is to facilitate external trade and payments and promote orderly development and maintenance of the foreign exchange market in India.
- **Objective:** FEMA aims to simplify and liberalize foreign exchange transactions in India, aligning with the country's shift toward a more open and market-oriented economic system. It seeks to promote external trade and payments while ensuring the orderly development of the foreign exchange market.

# Key Features

- **Liberalization of Foreign Exchange Transactions:** One of the significant changes introduced by FEMA is the liberalization of foreign exchange transactions. The act allows greater flexibility in foreign exchange dealings and reduces the need for prior approvals for many transactions.
- **Current Account Transactions:** FEMA distinguishes between current account transactions and capital account transactions. Current account transactions, which involve routine trade and services, are largely freely allowed, and restrictions are imposed only in exceptional cases.
- **Capital Account Transactions:** While current account transactions are relatively liberalized, certain capital account transactions, such as foreign direct investment (FDI) and foreign portfolio investment (FPI), are subject to specific regulations and approval processes.

# Key Features

- **Authorized Persons and Dealers:** FEMA designates authorized persons and authorized dealers to facilitate foreign exchange transactions. Authorized dealers, typically banks, play a crucial role in executing and reporting foreign exchange transactions.
- **Foreign Exchange Management Regulations:** FEMA empowers the Reserve Bank of India (RBI) to make regulations to manage foreign exchange in the country. The RBI issues Foreign Exchange Management Regulations to provide detailed guidelines and procedures for various aspects of foreign exchange transactions.
- **Penalties and Enforcement:** FEMA maintains provisions for penalties and enforcement to ensure compliance. Violations of the act can result in penalties, fines, or imprisonment, depending on the nature and severity of the offense.

# Key Features

- **Adjudication and Appellate Authorities:** FEMA establishes adjudicating authorities to hear cases related to violations and impose penalties. It also provides for appellate authorities to review decisions made by adjudicating authorities.
- **Integration with Global Standards:** FEMA aligns with international best practices in foreign exchange management. This alignment is crucial for facilitating cross-border transactions, attracting foreign investment, and integrating India into the global economy.