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NOTES

Types of Exchange Rates

- The exchange rate systems which countries follow can be categorized or divide into 3 types
- 1. Fixed or pegged exchange rate system.
- 2. floating exchange rate system.
- 3. managed floating exchange rate system.

1. Fixed Exchange Rate System

- This is official exchange rate and it is the duty of the central bank of the country, to maintain that rate stable. So it has to keep large stocks of major foreign currencies.
- Central bank has to sell forex if there is a shortage of foreign currencies in the forex market and buy them in case they in excess supply in the forex market in order to keep the rate stable

Fixed exchange rate is justified on the following grounds

- Helps in the stable growth of foreign trade.
- Prevents speculation.
- Prevents sudden outflow of FPI and FII as exchange rate does not change.
- The fixed exchange rate system worked well till 1970s.but after that it stopped due various problems.

2. Floating or flexible exchange rate system

- It is a exchange rate system where exchange rate is determined by market forces of demand and supply of foreign currencies. Currency's value changes as per foreign exchange market.
- It is a self-correcting system of exchange rate and BOP deficit or surplus is automatically corrected by changes in the exchange rate.
- Floating exchange rate system is justified on the following grounds;
- Automatic adjustment of BOP.
- Freedom in implementing domestic policies.
- No need to keep large stocks of foreign currency reserves.
- It can adjust to external shocks. Eg rise or fall in crude oil prices.
- No govt. interference in foreign exchange markets.

3. Managed floating exchange rate

- It is the current international system of exchange rate followed by most countries.
- Under this system, the exchange rate is freely allowed to be determined by foreign exchange market forces of demand and supply.
- But if there are too many fluctuations and exchange rate turns volatile then central bank will intervene to stabilize exchange rate.
- In cases of extreme appreciation or depreciation of currency govt or central bank intervenes- Managed float.
- Central bank may allow currency value to float freely between a upper limit-ceiling- and lower limit- floor. A band.
- Here govt intervention is used to stabilize exchange rates in the short run but in the long run a managed float exchange rate allows market forces to determine exchange rates.
- central banks intervene- dirty float