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EDITORIAL ANALYSIS → 14 JULY 2022 → THE INDIAN EXPRESS:

FOREIGN CURRENCY EXCHANGE RATE SYSTEM:

- **Different Exchange Rates:**

- **Free Floating currency exchange rate:**

- The rate is freely set by market forces, making it the simplest form of system, and the monetary authorities forbid any involvement in the market for exchange rates.
- The rate can change at any time and by any amount under this system.
- Flexible exchange rates are set every day by the forces of supply and demand in the market, free from any constraints imposed by state policy.
- Benefits: A very transparent and effective market.

- **Fixed rate of currency exchange:**

- Exchange rates are kept constant or only permitted to fluctuate within extremely specific limits, such as 1% above or below the initial set of rates, under a fixed exchange rate regime.
- A country's local currency is given a par value in terms of gold, another currency, or a basket of currencies when it decides to fix its exchange rate.

- When the exchange rate starts to fluctuate excessively, the government steps in by devaluing or revaluing its own currency in relation to other currencies. The goal is to keep the exchange rate within the predetermined range.
- Direct or indirect government intervention are also possible.
- A shift in international reserves is required for direct action.
- Sterilized direct intervention, or simultaneous trading in the foreign exchange and treasury securities markets, is when the central bank intervenes in the foreign exchange market while making adjustments to prevent a change in the money supply.
- Influencing the variables that determine exchange rates by changing interest rates or other economic indicators is known as indirect intervention (income, inflation, etc.). There is no adjustment to reserves in this move.
- The Bretton Woods Agreement systems from 1944 to 1971 and the Euro zone from 1999 to 2002 are two examples of fixed exchange regimes.

- **Pegged Exchange Rate System:**

- Countries using a pegged exchange rate system "peg" the value of their currency to another currency or some other unit of account (e.g., gold, the European currency unit, etc.).
- As a result, while bilateral parity is upheld, the value of the home currency changes in relation to other currencies in line with that of the anchor country.
- The exchange rate in this system is determined by market forces.
- The government will step in to bring the price of the currency back within the acceptable range if the exchange rate fluctuates beyond or below the predetermined limitations.
- Positive aspects of a fixed exchange rate Some nations prefer a pegged currency rate because it makes the government's pledge to low inflation more credible.

- **Managed float exchange rate:**

- A managed floating exchange rate, commonly referred to as a "dirty float," is a type of exchange rate regime in which the exchange rate is neither completely set nor completely free (or floating).
- Instead, central bank intervention maintains the currency's value within a range versus another currency (or against a basket of currencies).
- In that there are no established borders and exchange rates might alter daily, it is similar to a freely floating exchange rate.
- The distinction is that the government has the ability to step in and limit the amount of movement in one direction of the currency rate.
- In a managed float, the long-term objective is to avoid abrupt changes, while short-term action does not have a specific target rate in mind.
- In order to prevent instances of currency overvaluation or undervaluation, a managed floating exchange rate gives the central bank the authority to determine a corridor for the exchange rate.
- One of the reasons this strategy is referred to as "dirty" is that some governments specify bands within which the currency rate might vary.

- **World currency exchange rate systems:**

- The majority of developed nations have free-floating exchange rate systems, which prohibit central banks from intervening in foreign exchange markets to control currency movements.
- On the other side, there are nations with fixed parities with the US dollar, like Hong Kong, where the monetary policy of the central bank is used to uphold the peg.
- Most developing nations fall midway between these two extremes.
- They are primarily distinguished by "managed floating" or a "pegged" currency rate regime.

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- **Indian exchange rate system:**

- India's currency rate policy has changed over the years, going from a par value system to a basket-peg and ultimately to a managed float exchange rate regime.
- The rupee was paired with the pound sterling after the Bretton Woods System collapsed in 1971.
- The rupee was tied to a basket of currencies starting in September 1975 in order to address the drawbacks of a single currency peg and provide exchange rate stability through the early 1990s.
- India made the transition from a fixed peg to the US dollar to a "market determined exchange rate" in 1993.
- This was a component of the early 1990s' liberalisation and deregulation policies.
- Since then, there has been a currency market, in which the Reserve Bank of India actively participates.
- To stop the rupee from strengthening, RBI has begun interfering in the foreign exchange market.
- India's exchange rate was categorised by IMF in 2004 as "managed floating with no pre-determined direction for the exchange rate."

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