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TOPIC :- FIXED RATE AND FLEXIBLE RATE OF EXCHANGE

Under inconvertible paper money standard, there can be two types of exchange rates namely as fixed rate and flexible rate. Under the present monetary system of the International Monetary Fund, fixed or flexible exchange rate are known as pegged exchange rates or par values. In a strict sense, however, fixed exchange rate refers to the international gold standard under which countries defined their currencies in gold at a ratio assumed to be fixed indefinitely. But in the present context, by fixed exchange rates, we mean the adjustable page of the IMF system rather than the old system of international gold standard. In fact, IMF was established with the object of stabilising the rates of exchange, with proper safeguards for adjustments wherever necessary. On the other hand, free or flexible exchange rates are left uninterrupted by the monetary authorities to be determined by the ~~market~~ forces of demand and supply in the foreign exchange market. Thus, flexible exchange rates are determined by the conditions of demand for and supply of foreign exchange and are perfectly free to fluctuate according to the changes in the demand and supply forces, if there are no restrictions on buying and selling in the foreign exchange market. The free and floating rate is allowed to seek its own level, as no par of exchange is fixed. sometimes when a currency is floated a former fixed par no longer applies, and the government also does not care to enforce it.

Under the system of fixed pars, as adopted by the IMF member nations, the exchange rate is determined by the government and enforced either by pegging operations, or by resorting to some form of exchange control and sometimes by a healthy combination of both these methods. Under the pegging operation, the government fixes an official par of exchange and tries to enforce it through central bank or a kind of exchange stabilisation fund which enters foreign exchange market and purchase its currency when the market rate falls below the specified level and sell it when the rate rises above a particular mark. This system of pegged rates of exchange is government propped up. There is however, one major defect in this system that if the market rate of exchange has a consistent tendency to decline, pegging operations would be very expensive, as it would lead to a heavy reduction in the exchange reserves of the country concerned.

Recently, therefore, it has been held by many that the IMF's system of adjustable stable exchange rates is not desirable and that free or fluctuating exchange rates would be more helpful in adjusting prevailing rates of exchange to their true value.

Merits of Fixed Exchange Rate System:-
Following are the merits of fixed exchange rate system:-

(I) It encourages development of international trade.
(II) It ensures a regular flow of foreign capital and supports progressive planning efforts.
(III) It facilitates long-term international investments.
(IV) It rules out speculative activities in foreign exchange.
(V) It gives an added incentive to the country to adjust its domestic affairs in order to maintain a fixed exchange rate.
(VI) It is desirable if multilateral trade transactions and agreements are to be encouraged through regional economic co-operation of different countries.
(VII) It systematises the world's monetary system. Hence, the IMF has adopted fixed or pegged exchange rate system.
(VIII) It assists in internal economic stabilisation

Since the merits of the system of fixed exchange rates mentioned above are substantial and carry much weight, the IMF aimed at maintaining stable or pegged exchange rates for its members.

Merits of Flexible Exchange Rate System-

Following are the merits of flexible exchange rate system:-

(i) It automatically deals with the problem of balance of payments.

(ii) It permits the country to adopt an independent monetary policy to maintain its domestic economic affairs.

(iii) It eases the liquidity problem, since there is no need to maintain large-scale reserves under the system.

(iv) It permits foreign exchange rates to be determined in its natural course.

(v) The system of flexible rates facilitates continuous adjustment, so that the adverse effect of a prolonged period of disequilibrium is avoided.

(vi) It permits the continued existence of free trade and convertible currencies.

(vii) It eliminates the need for official foreign exchange reserves.

Presently, however, International Monetary Fund favours a fixed exchange rate system with some relaxation. Floating of exchange rate is permitted under certain circumstances.

Against the two extremes of rigidity fixed and freely flexible exchange rates a system of controlled or managed flexibility is suggested on practical considerations into the exchange rate regime. The focus on intermediate regime between fixed and floating exchange rate is desirable for a tendency to eliminate the drawbacks and capture the merits of both extreme systems.