Learning outcomes

After studying this unit, you should be able to:

- Know what is exchange control
- Objectives of exchange control
- Define Exchange rate system
- determine exchange rates
- classify exchange

Introduction:

Exchange control is one of the important means of achieving certain national objectives like an improvement in the balance of payments position, restriction of inessential imports and conspicuous consumption, facilitation of import of priority items, control of outflow of capital and maintenance of the external value of the currency.

Under the exchange control, the whole foreign exchange resources of the nation, including those currently occurring to it, are usually brought directly under the control of the exchange control authority (the Central Bank, treasury or a specially constituted agency). Dealings and transactions in foreign exchange are regulated by the exchange control authority. Exporters have to surrender the foreign exchange earnings in exchange for home currency and the permission of the exchange control authority have to be obtained for making payments in foreign exchange. It is generally necessary to implement the overall regulations with a host of detailed provisions designed to eliminate evasion.

The allocation of foreign exchange is made by the exchange control authority, on the basis of national priorities.

Though the exchange control is administered by a central authority like the central bank, the day-to-day business of buying and selling foreign exchange is ordinarily handled by private exchange dealers, largely the exchange departments of commercial banks. For example, in India there are authorised dealers and money changers, entitled to conduct foreign exchange business.

Objectives of Exchange Control

The important purposes of exchange control are outlined below.

make the augmentation of resources far certain strategic needs like defence more easy.

To Conserve Foreign Exchange

The main objective of foreign exchange regulation in India, as laid down in the Foreign Exchange Regulation Act (FERA), 1973, is the conservation of the foreign exchange
resources of the country and the proper utilisation thereof in the interest of the national development. This is one of the important objectives of foreign exchange regulation of many other countries too.

**To Check Capital Flight**
Exchange control may be employed to prevent flight of capital from the country and to regulate the normal day-to-day capital movements. As Krause remarks, if adequately implemented and enforced, exchange control tends to be highly effective in curbing erratic outflows of capital. When exchange control authorities refuse to sell foreign exchange for this purpose, they close the only legal avenue through which capital may leave a country.

**To Improve Balance of Payments**
Exchange control is one of the measures available to improve the balance of payments position. This can be achieved by restricting imports by means of exchange control.

**To Curb Conspicuous Consumption**
In the developing countries especially, there is a craze for the consumption of imparts, which are regarded as inessential 'luxury' goods. Exchange control may be used to prevent their import and, thereby, their consumption.

**To make Possible Essential Imports**
Due to the non-availability or scarcity within the country, the developing countries generally have to import capital goods, knowhow and certain essential inputs and consumer goods. By giving priority to such imports in the allocation of foreign exchange, exchange control may ensure availability of foreign exchange for these imports.

**To Protect Domestic Industries**
Exchange control may also be employed as a measure to protect domestic industries from foreign competition.

**To Check Recession-induced Exports into the Country**
If foreign economies are undergoing recession when the domestic economy is free from it, the decline in prices of foreign goods, due to the recession, may encourage their exports into the country not yet affected by recession. Exchange control may be employed to check such recession-induced exports into the country.

**To regulate foreign companies.**
Exchange Control may also seek to regulate the business of foreign companies in the country. For instance, the FERA provided that non-residents, foreign national resident in India, companies (other than banking companies) incorporated abroad and having more than 40 per cent non-resident interest could not carry on in India, or establish a branch/office or other place of business in the country for carrying on any activity of a trading, commercial or industrial revenue, without the permission of the Reserve Bank of India.
To regulate Export and Transfer of Securities
Exchange control may be employed also for the purpose of controlling the import and transfer of securities from the country. The FERA, for instance, prohibited the sending or transferring of securities from the country to any person outside India, without the permission of the Reserve Bank of India.

Facilitate Discrimination and Commercial Bargaining
Exchange control offers scope for discrimination between different countries. It would be used to accord exchange concessions, on a reciprocal basis, between different countries.

Enable the Government to Repay Foreign Loans
If the system of exchange control empowers the government to acquire foreign exchange from the residents of the country, it becomes easy for the government to repay foreign loans.

To Lower the Price of National Securities held Abroad
It may be possible to reduce the price of national securities held abroad by preventing nationals from buying them. This would enable the government to purchase such securities at a lower price.

To Freeze Foreign Investments and Prevent Repatriation of Funds
Exchange control may be used to freeze investments, including bank deposits, of foreigners in the home country and to prevent the repatriation of funds out of the country. This is sometimes done by hostile countries.

To Obtain Revenue
Governments may use exchange control to obtain some revenue. The government/government agency can make profit out of the foreign exchange business by keeping a certain margin between the average purchase price and the average selling price of the foreign exchange.

Methods of Exchange Control
The various methods of exchange control may be broadly classified into (1) Unilateral methods and (2) Bilateral/multilateral methods.

Unilateral Methods
Unilateral measures refer to those methods which may be adopted by a country unilaterally i.e., without any reference to or understanding with other countries. The important unilateral methods are outlined below.

Regulation of Bank Rate
A change in the bank rate is usually followed by changes in all other rates of interest and this may affect the flow of foreign capital. For example, when the internal rates of interest rise, foreign capital is attracted to the country. This causes an increase in the supply of foreign currency and the demand for domestic currency in the
foreign exchange market and results in the appreciation of the external value of the currency. A lowering of the bank rate is expected to produce the opposite results.

Regulation of Foreign Trade The rate of exchange may be controlled by regulating the foreign trade of the country. For example, by encouraging exports and discouraging imports, a country can increase the demand for, in relation to supply, its currency in the foreign exchange market and thus bring about an increase in the rate of exchange of the country's currency.

Rationing of Foreign Exchange By rationing the limited foreign exchange resources, a country may restrict the influence of the free play of market forces of demand and supply and thus maintain the exchange rate at a higher level.

Exchange Pegging Exchange pegging refers to the policy of the government of fixing the exchange rate arbitrarily either below or above the normal market rate. When it is fixed above the free market rate, it is known as pegging up and when it is fixed below the free market rate, it is known as pegging down. Exchange pegging is resorted to, generally, during war times to prevent violent fluctuations in the exchange rate.

Multiple Exchange Rate Multiple exchange rates refer to the system of the fixing, by a country, of the different rates of exchange for the trade or different commodities and/or for transactions with different countries. The main object of the system is to maximise the foreign exchange earning of country by increasing exports und reducing imports. The entire structure of the exchange rate is devised in a manner that makes imports cheaper and exports more expensive. The multiple exchange rate system has been severely condemned by the IMF.

Exchange Equalisation Fund The main object of the Exchange Equalisation Fund, also known as the Exchange Stabilisation Account, is to stabilise the exchange rate of the national currency through the sale and purchase of foreign currencies. When the demand for domestic currency exceeds its supply, the fund starts purchasing foreign currency with the help of its own resources. This results in an increase in the demand for foreign currency and increases the supply of the national currency. The tendency of the rate of exchange of the national currency to rise can thus be checked.

When the supply of the national currency exceeds demand and the exchange rate tends to fall, the Fund. sells the foreign currencies and this increases the supply of foreign currencies and arrests the tendency of the exchange rate of the domestic currency to fall. This sort of an operation may be resorted to eliminate short term fluctuations.

Blocked Accounts In the case of blocked accounts, foreigners are prevented from withdrawing money from their deposits with banks, for the purpose of remitting abroad. This measure makes the foreign exchange position of the country more comfortable. This is generally regarded as a wartime measure. Under this method, domestic debtors may be required to deposit their dues to foreign creditors into specifically designated bank accounts.
Bilateral/Multilateral Methods

The important bilateral/multilateral methods are the following:

Private Compensation Agreement Under this method, which closely resembles barter, a firm in one country is required to equalise its exports to the other country with its imports from that country so that there will be neither a surplus nor a deficit.

Clearing Agreement Normally, importers have to make payments in foreign currency and while exporters are paid in foreign currency. Under the clearing agreement, however, importers make payments in domestic currency to the clearing account and exporters obtain payments in domestic currency from the clearing fund. Thus, under the clearing agreement, the importer does not directly pay the exporter and hence, the need for foreign exchange does not arise, except for settling the net balance between the two countries.

Standstill Agreement The standstill agreement seeks to provide debtor country some time to adjust its position by preventing the movement of capital out of the country through a moratorium on the outstanding short-term foreign debts.

Payments Agreement Under the payments agreement, concluded between a debtor country and a creditor country, provision is made for the repayment of the principal and interest by the debtor country to the creditor country. The creditor country refrains from imposing restrictions on the imports from the debtor country in order to enable the debtor to increase its exports to the creditor. On the other hand, the debtor country takes necessary measures to encourage exports to and discourage imports from the creditor country.

EXCHANGE RATE SYSTEMS

Broadly, there are two important exchange rate systems, namely the fixed exchange rate system and flexible exchange rate system.

Fixed Exchange Rates
Countries following the fixed exchange rate (also known as stable exchange rate and pegged exchange rate) system agree to keep their currencies at a fixed, pegged rate and to change their value only at fairly infrequent intervals, when the economic situation forces them to do so.

Under the gold standard, the values of currencies were fixed in terms of gold. Until the breakdown of the Bretton Woods System in the early 1970, each member country of the IMF defined the value of its currency in terms of gold or the US dollar and agreed to maintain (to peg) the market value of its currency within ±1 per cent of the defined (par) value. Following, the breakdown of the Bretton Woods System, some countries took to managed floating of their currencies while a number of countries still embraced the fixed exchange rate system.
Arguments for the Stable Exchange Rate System
The relative merits and demerits of the fixed and flexible exchange rate systems have long been a topic for debate. A number of arguments have been put forward for and against each system. The important arguments supporting the stable exchange rate system:
(i) Exchange rate stability is necessary for orderly development and growth of foreign If exchange rate stability is not assured, exporters will be uncertain about the amount they will receive and importers will be uncertain about the amount they will have to pay. Such uncertainties and the associated risks adversely affect foreign trade. A great advantage of the fixed exchange rate system is that it eliminates the possibilities of such uncertainties and risks.
(ii) Especially the developing countries, which have a persistent balance of payment deficits, should necessarily adopt the stable exchange rate sys.
(iii) Exchange rate stability is necessary to attract foreign capital investment as foreigners will not be interested to invest in a country with an unstable currency. Thus, exchange rate stability is necessary to augment resources and foster economic growth.
(iv) Unstable exchange rates may encourage the flight of capital. Exchange rate stability is necessary to prevent its outflow.
(v) A stable exchange rate system eliminates speculation in the foreign exchange market.
(vi) A stable exchange rate system is a necessary condition for the successful functioning of regional groupings and arrangements among nations.
(vii) Foreign trade plays a very important role in case of a number of countries. As we have seen in the first chapter, for certain countries, the value of foreign trade exceeds GNP, while for others, the value of foreign trade is more than 50 percent of their GNP. Exchange rate stability is especially important for such countries to ensure the smooth functioning of the economy. Its absence will give rise to uncertainties and this would disturb the foreign trade sector and, thereby, the economy.
(viii) A stable exchange rate system is also necessary for the growth of international money and capital markets. Due to the uncertainties associated with unstable exchange rates, individuals, firms and institutions may shy away from lending to and borrowing from the international money and capital markets.
Flexible Exchange Rates
Under the flexible exchange rate system, exchange rates are freely determined on open market primarily by private dealings, and they, like other market prices, vary from day-to-day. Under the flexible exchange rate system, the first impact of any tendency toward a surplus or deficit in the balance of payments is on the exchange rate. A surplus in the balance of payments will create an excess demand for the country's currency and the exchange rate will tend to rise. On the other hand, a deficit in the balance of payments will give rise to an excess supply of the country’s currency and the exchange rate will tend to fall.

Automatic variations in the exchange rates, in accordance with the variation in the balance of payment position, tend to automatically restore the balance of payments equilibrium. A surplus in the balance of payments increases the exchange rate. This makes foreign goods cheaper in terms of the domestic currency and domestic goods more expensive in terms of the foreign currency. This, in turn, encourages imports and discourages exports, resulting in the restoration of the balance of payments equilibrium. On the other hand, if there is a payments deficit, the exchange rate falls and this makes domestic good cheaper in terms of the foreign currency and foreign goods more expensive in terms of the domestic currency. This encourages exports discourages imports and thus helps to establish the balance of payments equilibrium: Theoretically, this is how the flexible exchange rate system works.

Cases for and against Flexible Exchange Rates
A number of economists strongly advocate the adoption of the flexible exchange rate system. Nobel laureate, Milton Friedman, for instance, argues,

There is scarcely a facet of international economic policy for which the implicit acceptance of a system of rigid exchange rates does not create serious and unnecessary difficulties.

He is of the view that

...sooner a system of flexible exchange rates is established, the sooner unrestricted multilateral trade will become a real possibility. And it will become one without, in any way, interfering with the pursuit by each nation of domestic economic stability according to its own rights.

A number of economists, however, point out that certain serious problems are associated with the system of flexible exchange rates. We present here some important arguments against and for flexible exchange rates.

1. Flexible exchange rates present a situation of instability, creating uncertainty and confusion. Friedman disputes this view and argues that a flexible exchange rate need not be an unstable exchange rate. If it is, it is primarily because there is underlying instability in the economic conditions governing international trade. And a rigid exchange rate may, while itself remaining nominally stable, perpetuate and accentuate other elements of instability in the economy. The mere fact that a rigid official exchange rate does not
change while a flexible rate does is no evidence that the former means greater stability in any more fundamental sense.

2. The system of flexible exchange rates, with its associated uncertainties, makes it impossible for exporters and importers to be certain about the price they will have to pay or receive for foreign exchange. This will have a dampening effect on foreign trade.

Friedman encounters this objection by pointing out that under flexible exchange rates, traders can almost always protect themselves against changes in the rate by hedging in the future market. Such markets in foreign currency readily develop when exchange rates are flexible. However, as Sodersten points out, it is certainly true that no market exists today that can protect against all the risks connected with a system of flexible exchanges, and it is doubtful if such a market can be established in the future, if a system of flexible exchanges were introduced. A system of flexible exchanges might, (therefore, have a considerably dampening effect on the volume of foreign trade.

3. Under flexible exchange rates, there will be widespread speculation, which will have a destabilising effect. Against this, it is argued that normally, speculation has a stabilising influence on exchange rates. Friedman observes that if speculation is supposed to be destabilising, it implies that speculators lose money on their activity. However, Farrell question this argument and shows that it might be possible, under what seems to be fairly general assumptions, that speculation can be, at the same time, profitable and destabilizing.

4. The system of flexible exchange rates gives an inflationary bias to an economy. When the currency depreciates due to payments deficit, imports become costlier and this stirs up an inflationary spiral. The supporters of the flexible exchange rates, however, counter this criticism by stating that when Imports become costlier, the demand for them falls, compelling foreign suppliers to reduce prices. Though it is theoretically possible, it may not be realised. The general feeling is that flexible exchange rates may have an inflationary impact on the economy.

We have reviewed the arguments for and against the fixed and flexible systems. Which system, then, should a country adopt?

The answer will depend on circumstances. It will depend on the characteristics of the economy, and it will change with time as the economy changes. Value judgements are also involved, and ultimately the answer could depend on values and views of a political nature.

EXCHANGE RATE CLASSIFICATIONS

Following are different types of exchange rate regimes and how they work.

**Single Currency Peg:**

The country pegs to a major currency-usually the US dollar or the French franc-with infrequent adjustment of the parity. (About number of developing countries have single currency pegs).

**Composite Currency Peg:**
The country pegs to a basket of currencies of major trading partners to make the pegged currency more stable than if a single currency peg were used. The weights assigned to the currencies in the basket may reflect the geographical distribution of trade, services, or capital flows. They may also be standardised, as in the SDR and the European Currency Unit.

Limited Flexibility vis-a-vis a Single Currency The value of the currency is maintained within certain margins of the peg (this system applies to four Middle East countries).

Limited Flexibility through Cooperative Arrangements This applied to countries in the exchange rate mechanism of the European Monetary System (EMS) and was a cross between a peg of individual EMS currencies to each other and a float of all these currencies jointly vis-a-vis non-EMS currencies.

Greater Flexibility through Adjustment to an Indicator The currency is adjusted more or less automatically to changes in selected indicators. A common indicator is the real effective exchange rate, which reflects inflation-adjusted changes in the currency vis-a-vis major trading partners.

Greater Flexibility through a Managed Float The Central bank sets the rate but varies it frequently. Indicators for adjusting the rate include, for example, the balance of payments position, reserves, and parallel market developments. Adjustments are not automatic.

Full Flexibility through an Independent Float Rates are determined by market forces. Some industrial countries have floats—except for the EU countries—but the number of developing countries in this category has been increasing in recent years.

**CONVERTIBILITY OF THE RUPEE**

Free convertibility of a currency means that the currency can be exchanged for any other convertible currency, without any restriction, at the market determined exchange rates. Convertibility of the rupee, thus means that the rupee can be freely converted into dollar, pound sterling, yen, Deutsche mark, etc. and vice versa at the rates of exchange determined by the demand and supply forces. After the collapse of the Bretton Woods System in 1971, the rupee was pegged to pound sterling for four years after which it was linked to a basket of 14 and later 5 major currencies. In 1981, a rise in dollar due to high interest rates in the US led to rupee appreciation which adversely affected India's exports due to fall in the export profitability. It prompted the Reserve Bank of India to experiment with a managed float, pegging the rupee to dollar and pound sterling alternatively depending on which was going down, to guard against the appreciation of the rupee that would adversely affect the exports.

A considerable exchange rate adjustment (devaluation) was made in July 1991. (For details see the Chapter, Devaluation.) As a part of the economic policy reforms, partial convertibility of the rupee on the current account was announced by the Finance Minister in his Budget speech for 1992-93 and the rupee became partially convertible since March 1992. The move towards convertibility of
the rupee was in line with the worldwide trend towards currency convertibility. According to the IMF, 70 countries accepted current account convertibility by 1990 while another 10 joined them in 1991. Many other countries including the East European countries and Russia have been contemplating the convertibility move.

According the Liberalised Exchange Rate Management System (LERMS) introduced in March 1992, 60 per cent of all receipts under current transactions (merchandise exports and invisible receipts) could be converted at the free market exchange rate quoted by the authorised dealers. The rate applicable for the remaining 40 per cent was the official rate fixed by the Reserve Bank. This 40 per cent of the total foreign exchange receipts under the current account was exclusively meant to cover government needs and to import essential commodities. In addition, foreign exchange at official rate was to be made available to meet 40 per cent of the value of the advance licenses and special import licenses.

In short, it was a dual exchange rate system.

**Why Partial Convertibility?**

One major reason for introducing partial convertibility was to make foreign exchange available at a low price for essential imports so that the prices of the essentials would not be pushed up by the high market price of the foreign exchange.

It was risky to introduce full convertibility when the current account showed large deficit. While introducing the partial convertibility, the government announced its intentions to introduce full convertibility on the current account in three to five years. However, full convertibility on trade account was introduced by the Budget for 1993-94.

The fact that the free market rate was ruling fairly stable at a reasonable level might have encouraged the government to introduce full convertibility. Rupee was showing remarkable stability in the months which followed the Introduction of the full convertibility.

**Capital Account Convertibility**

The convertibility of the capital account is usually introduced only after the introduction of the current account for a reasonable time, stabilisation programmes have been successfully carried out and favourable conditions have been ensured.

The introduction of capital account convertibility at least convertibility for certain types of capital flows-helps attract resources from abroad. It also enables residents to hold internationally diversified investment portfolios, thereby having more risk bearing capacity. However, capital account convertibility cannot be introduced until certain conditions are satisfied. "In the absence of confidence in the macroeconomic stability and the competitiveness of domestic enterprises, establishment of capital account convertibility entails the risks of capital flight and greater volatility in exchange rate, external reserves or interest rate. It is because of this, many countries have maintained
various restrictions on various types of capital flows until their economies are well developed."
It may be noted that under completely free capital account convertibility an Indian can sell his property here and take the money out of the country. Due, to such factors, even when capital account convertibility is introduced, several restrictions may have to be attached.

Merits of Convertibility
The convertibility or the floating of the Rupee has certain avowed merits.

(i) It gives an indication of the real value of the rupee.
(ii) It encourages exports by increasing the profitability of the exports
(iii) profitability increases as the free market rate is higher than the official exchange rate.
(iv) It encourages those exports with no or less import intensity. As the proportion of the imported inputs in the exportables increases, the profitability cause of the higher free market exchange rate gets correspondingly reduced. This could encourage import substitution in export production.
(v) The high cost of foreign exchange could encourage import substitution in other areas also It provides incentives for remittances by NRIs.
(vi) The convertibility and the liberalisation of gold imports have been expected to make illegal remittances and gold smuggling less attractive thereby increasing the remittances through proper channels.
(vii) It is described as a self balancing mechanism because the total imports and other current account payments will be confined to the total current account receipts unless there are imports financed by foreign currency loans.

Points (ii) to (v) Of bQ8Ud on the assumption that Rupee will not appreciate.

Problems:
The convertibility would cause some problems unless certain conditions are satisfied.
(i) Convertibility could cause an increase in prices because of the increase in the import prices.
(ii) Under full convertibility, if the free market exchange rate is very high, the cost of essential imports will correspondingly increase.
(III) If the current account balance is not kept under control, the free market rate would rise very high.

Pre-requisites
For the successful functioning of the convertible system, certain essential conditions will have to be satisfied. These include:
(i) Maintenance of domestic economic stability
(ii) Adequate foreign exchange reserves
(iii) Restrictions on inessential imports as long as the foreign exchange position is not very comfortable
(iv) Comfortable current account position
(v) An appropriate industrial policy and a conducive investment climate
(vi) An outward oriented development strategy and sufficient incentives for export growth.

**Experiences of Other Countries**
The experiences of other countries with currency convertibility present a fixed picture. Britain which introduced full convertibility in July 1947 had to beat a hasty retreat the very next month because of large scale flight of capital. In 1958 Britain introduced restricted convertibility. South Korea which faced problems with partial convertibility in the beginning rescinded it in 1985 but ultimately restored it in 1989 and succeeded. Fiji which introduced current account convertibility in 1985 made a retreat in 1987. Although Pakistan's balance of payments crisis was more severe than that of India, after the convertibility their rupee more or less stabilised. The experiences of countries like Mexico, Argentina, Peru and Chile have also been encouraging.

Also see the Appendix on Capital Account Convertibility.

**QUESTIONS FOR SELF ASSESSMENT**

1. Explain how foreign exchange rates are determined?

2. Discuss the purchasing power parity theory?

3. What are the objectives and methods of exchange control?

4. Write notes on the following:
   (i) Foreign exchange:
   (ii) Foreign exchange market:
(iii) Spot and forward exchange rates:

(iv) Arbitrage:

(v) Balance of Payments theory:

(vi) Stable exchange rate system:

(viii) Flexible exchange rate system:
(viii) Exchange rate classifications:-----------------------------------------------
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SUGGESTED READINGS

IMF, Annual Reports and IMF survey.
POINTS TO PONDER:

### Objectives of Exchange Control

- To Conserve Foreign Exchange
- To Check Capital Flight
- To Improve Balance of Payments
- To Curb Conspicuous Consumption
- To make Possible Essential Imports
- To Protect Domestic Industries
- To Check Recession-induced Exports into the Country
- To regulate foreign companies

### Exchange Rate Systems

- **Fixed Exchange Rates**
- **Arguments for the Stable Exchange Rate System**
- **Flexible Exchange Rates**

### Exchange Rate Classifications

- **Single Currency Peg**
- **Composite Currency Peg**