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Distinction Between Flexible and Fixed Exchange Rate Systems

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INTRODUCTION

- There could be a disparity of exchange rate types in the foreign exchange market
- The two main systems are Flexible Exchange Rate and Fixed Exchange Rate
- There exists other hybrid systems such as Crawling Peg and Managed Floating in between the two extreme rates (Barguelli et al., 2018)
- Fixed Exchange Rates are determined by Governments
- Flexible Exchange rates are influenced by market drive



Fixed Exchange Rate System

- This rate is authoritatively fixed by financial authorities and are not influenced by market drives
- Only a negligible deviation from fixed values are probable
- Foreign principal banks stand prepared to purchase their exchanges at a fixed values
- It was employed under Gold Standard System whereby every nation was committed to exchange their currency spontaneously into gold at a fixed value
- The transaction referred to as mint per value of exchange

Merits

- Ensures exchange rate stability encouraging foreign commerce
- Advances the harmonization of macro strategies of nations in a sovereign global economy

Fixed Exchange Rate System Cont...

- Guarantees that main commercial instabilities in associate nations do not arise
- Averts capital expenditure and speculation in foreign exchange market
- They are more conducive to expansion of world trade

Demerits

- Distress of devaluation
- Deprivation of the benefits of the free market
- Possibilities of over-valuation or under-valuation

Flexible Exchange Rate System

- Exchange rate is influenced by forces of supply together as well as demand of foreign exchange markets
- The currency worth is permitted to adjust freely or fluctuate depending on the variation in supply and demand of external exchange
- Lack of official involvement in the external exchange marketplace i.e. in India
- Principal bank in India allowed the conversation rate to alter so as to associate the demand and supply for foreign exchange without intervention (Willett & Wihlborg, 2019)
- The marketplace is eventful all the time because of exchange rate fluctuations



Flexible Exchange Rate System cont...

Merits

- Surplus or deficit in balance of payments are corrected automatically
- Governments are not required to hold any foreign exchange reserves
- Assists in optimum resource distribution
- Frees governments from problems regarding balance of payments

Demerits

- Inspires assumption leading to variations in external conversation degree



Flexible Exchange Rate System cont....

- Wide variation in conversion rate hinders foreign commerce and resources circulation among nations
- Produces inflationary stress when import charges rise as a result of devaluation of currency

Managed Floating

- Mentions a gradual adjustment structure in the conversation level made intentionally by principal bank to effect the worth of its own currency relative to others (Barguelli et al., 2018)
- Why is it done?



Conclusion

- Fixed exchange rate is officially fixed by governments in terms of gold
- No changes occur in terms of supply and demand foreign exchange
- Flexible exchange rate is influenced by supply and demand forces
- It transforms with regard to supply and demand of foreign currency
- Governments do not intervene in flexible exchange rate systems (Willett & Wihlborg, 2019)

References

Barguelli, A., Ben-salha, O., & Zmami, M. (2018). *Exchange Rate Volatility And Economic Growth*. *Journal Of Economic Integration*, 33(2), 1302-1336.

Willett, T. D., & Wihlborg, C. (2019). *The Relevance Of The Optimum Currency Area Approach For Exchange Rate Policies In Emerging Market Economies*. In *Exchange-rate Policies For Emerging Market Economies* (Pp. 61-79). Routledge.

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