UNIT-5

Balance of Payment

CHAPTER 7

FOREIGN EXCHANGE RATE

TOPIC
Merits and demerits of Flexible and Fixed Exchange Rate

Revision Notes

Merits of Fixed Exchange Rate:

(1) Promotion of international trade
(2) Incentives of foreign capital
(3) Acceleration in capital formation
(4) Economic planning
(5) Source of economic benefit
(6) Helpful in maintaining favourable Balance of Payments
(7) Ensures stability in exchange rate
(8) Helpful to check inflation

Demerits of Fixed Exchange Rates :

(1) Neglects National interest
(2) Control over various sectors
(3) High fluctuation in exchange rates
(4) Intervention of Central Bank

Merits of Flexible Exchange Rate System :

(1) Simple system
(2) Continuous adjustment
(3) Lesser requirement of reserve funds
(4) Efficient utilization of resources

Demerits of Flexible Exchange Rate System :

(i) Bad effects of less elasticity
(ii) Creates uncertainty
(iii) Instability in international trade

Merits of Managed Floating exchange Rate:

(1) Improved Balance of Payment
(2) Reduced risk of inflation and deflation
(3) Balances the Economy
(4) Long-term Growth Potential

Demerits of Managed Floating Exchange Rate:

(1) Large forex reserve needs to be maintained
(2) Speculation
(3) Conflict with macroeconomic objectives

Objective Type Questions

(1 mark each)

(A) STAND ALONE MCQS

1. Which of the following is not the merit of Fixed Exchange Rate System?

A. It helps in the promotion of International Trade.
B. It helps in boosting the Economic Planning.
C. It requires continuous adjustments.
D. It accelerates Capital Formation. [U]

Ans. Option **(C)** is correct.

Explanation: In case of fixed exchange rate system, the exchange rates are fixed by central bank or government and so they do not need continuous adjustments like in the case of flexible exchange rates.

2. Which of the following is the correct merit of flexible exchange rate?

A. It is a very simple system.
B. It creates certainty in the market.

C. It helps in creating stability in foreign trade.

D. It boosts the exports of relatively elastic goods. U

Ans. Option **(A)** is correct.

Explanation: The flexible exchange rate system is a very simple system because the government does not have to define the rates but it is decided automatically by the market mechanism of demand and supply.

AI **3. Read the following statements 1 and 2 and choose the correct alternatives:**

Statement 1: Fixed Exchange Rate is fixed and so it helps in the proper control over inflation.

Statement 2: Fixed Exchange Rate is a great source of economic benefit C

A. Both Statement 1 and 2 are correct.

B. Both Statement 1 and 2 are incorrect.

C. Statement 1 is only correct.

D. Statement 2 is only correct.

Ans. Option **(A)** is correct.

Explanation: Fixed Exchange rate helps in the proper control over the inflation as the government or the central bank can increase or decrease the money supply easily. It also helps in economic benefit as the foreign exchange received can be easily exchanged for the domestic currency and is not influenced by the change in the fluctuation in the demand and supply.

AI **4. Read the following statements and choose the correct alternative:**

Statement 1: Flexible Exchange Rate System changes as per the market demand and supply.

Statement 2: Flexible exchange neglects national interest. C

Alternatives:

A. Both Statement 1 and 2 are correct.

B. Both Statement 1 and 2 are incorrect.

C. Statement 1 is only correct.

D. Statement 2 is only correct.

Ans. Option **(C)** is correct.

Explanation: In the flexible exchange rate system the exchange rate is determined by the market forces of demand and supply. This is done with the interest of the nation in the mind as it directly affects the market as per the situation of demand and supply. Thus, Statement 2 is false.

5. Rina said that " Fixed Exchange rate is good to bring stability in the foreign Exchange rate. Rajiv said, "Flexible Exchange rate shows the true prices of the product as it depends on the market forces of demand and supply. Ranveer said, "Flexible Exchange rate can be managed by the central bank." Who among them is correct? A

(i) Rina

(ii) Rajiv

(iii) Ranveer

Choose the correct option:

A. i and ii

B. ii and iii

C. i and iii

D. i , ii and iii

Ans. Option **(D)** is correct.

6. In case of managed exchange rate, the forex reserves are to be maintained by the central bank. Which of the following is the best reason for it?

A. The currency is devaluated by the central bank.

B. It allows the central bank to increase or decrease the demand of the foreign currency.

C. Both A and B

D. Neither A nor

Ans. Option **(B)** is correct.

Explanation: The central bank needs to maintain a large amount of forex reserve, in case of managed floating exchange rate system, so that when the demand for foreign exchange rises, the central bank can float the foreign exchange into the market from its forex reserve, bringing the stability in the economy. The reverse can be done in case of increase in the supply.

(B) ASSERTION-REASON

Direction: Read the Assertion (A) and Reason (R) in the following question and choose the correction alternatives:

A. Both Assertion (A) and Reason (R) is true and Reason (R) is the correct explanation of Assertion (A)

B. Both Assertion (A) and Reason (R) is true, but Reason (R) is not the correct explanation of (R)

C. Assertion (A) is true, but Reason (R) is false

D. Assertion (A) is false, but Reason (R) is true.

1. Assertion (A): Fixed Exchange rate helps in maintaining the favourable Balance of Payment.

Reason (R): The government can easily predict the imports and exports value and so they can easily help in the proper management of the international trade. U

Ans. Option **(A)** is correct.

Explanation: As the rates are fixed in the case of fixed exchange rate system, this enables the government to easily decrease the imports with respect to the decrease in exports and vice-versa. The government can also predict the true values of imports and exports so would already know how much to borrow from the market. Thus it helps in maintaining the favourable Balance of Payment.

AI **2. Assertion (A):** Flexible Exchange rate needs a continuous adjustment.

Reason (R): The exchange rate is determined by the market forces of demand and supply. U

Ans. Option **(A)** is correct.

Explanation: As the rates in the case of the flexible exchange rate is determined by the market forces of the demand and supply, it leads to the continuous adjustment of the exchange rate as according to the foreign exchange market.

3. Assertion (A): The imports of less elastic demand goods lead to the deficit balance of trade in case of the appreciation of the domestic currency in case of flexible exchange rate system.

Reason (R): In flexible exchange rate system, the market is affected by the demand for inelastic or less elastic goods. U

Ans. Option **(D)** is correct.

Explanation: In case of flexible exchange rate system, the demand for inelastic or less elastic goods, leads to a surplus balance of trade as imports becomes less expensive.

4. Assertion (A): Managed Floating Exchange rate system is ineffective when there is a lot of speculation in the market.

Reason (R): In case of managed floating exchange rate system, the government tries to manipulate the value of the currency through the central bank. U

Ans. Option **(B)** is correct.

Explanation: Speculation in the forex market can lead to a very sudden decrease or increase in the demand of the foreign currency. This will make it difficult for the central bank to influx in the foreign currency and stabilise the domestic currency. In such a case Managed Floating Exchange Rate becomes ineffective.

Subjective Type Questions :

SHORT ANSWER TYPE QUESTIONS-I (3 marks each)

Q. 1. How does fixed exchange rate guarantee the promotion of International Trade? U

Ans. In the case of fixed exchange rate the market forces of demand and supply do not affect the domestic currency. This stabilises the prices of the domestic market as well as the foreign market, making them unaffected by each other. The importers feel more confident and import without any problem. Even the exporters do not have to keep up with the changes in the foreign exchange rate. Thus, it will promote International Trade.

AI **Q. 2.** How is continuous adjustment in the case of Flexible Exchange rate is a good thing? U

Ans. In case of flexible exchange rate system, the exchange rate is to be continuously adjusted as per the market demand and supply of foreign exchange. This is a good thing as the true forces affect the foreign exchange continuously. It helps in anaysing true growth rate of the economy and also help to know about the true balance of payment crisis in the economy.

Q. 3. Why is flexible exchange rate system considered to be simple? U

Ans. Flexible exchange rate system is considered to be simple as the exchange rate is determined by the market forces of demand and supply. In such a case the government or the central bank do not have to calculate the exchange rate as it is automatically calculated. Thus the government can focus on more pressing issues of the economy.

Q. 4. How does the central bank control inflationary pressure in the case of managed floating exchange rate?

Ans. The central bank sells foreign exchange in the market to bring down the value of the foreign currency. This leads to appreciating the value of the domestic currency and making it a bit stronger than before. The imports become cheaper, and the raw materials from the foreign economy can be bought at cheaper rate. This leads to the control in the inflationary situation in the domestic market.

SHORT ANSWER TYPE QUESTIONS-II (4 marks each)

Q. 1. How does Fixed exchange rate system, accelerates capital formation and also as an incentive for foreign investment? C

Ans. Fixed Exchange rate system accelerated capital formation because:

a) Purchasing capital from the foreign country is comparatively easy as the exchange rate need not be calculated from time to time. **[1]**

b) The payment system faces no fluctuation over time and so the capital goods can be purchased without the effect of inflation. **[1]**

Fixed Exchange rate system is also an incentive for foreign capital because:

a) Foreign investors do not feel threatened of the fluctuations in the market. They feel that their investment is secure. **[1]**

b) As they feel the investment to be secured there is an increase in the foreign direct investment and foreign portfolio investment and the investors can earn profits. **[1]**

AI **Q. 2.** Even though Flexible Exchange rate is simple and ensures efficient utilization of resources, it creates uncertainty in the market. Comment. C

Ans. Flexible exchange rate is simple as the market forces of demand and supply fix the exchange rate and it ensures efficient utilisation of resources and the importers and exporters act according to the rise and fall in the exchange rate. **[1]**

Flexible exchange rate creates uncertainty because:

a) The exchange rate can change at any time as per the demand and supply of the foreign currency in the forex market.

b) The investors may not want to invest during the depreciation of the currency, which will further lead to uncertainty and depreciation.

c) The country can face a deficit in the balance of trade and so there could be depreciation at any sudden moment.

d) The exports and imports could change as per the changes in the exchange rate.

[Any 3] [3 × 1]

Q. 3. How does speculation effect the managed floating exchange rate system?

Ans. Speculation means future expectation of increase or decrease in the prices. In case when the prices of the foreign currency is expected to rise in the future, the demand for it will increase suddenly, putting a lot of pressure and leading to the depreciation of the domestic currency. In such a situation, the central bank tries to sell its foreign exchange reserve to try and stabilise the prices, but due to excessive pressure on the demand it does not have much effect. If the central bank sells too much of foreign currency in such a situation, it will lead to appreciation of the domestic currency leading to inflation or deflation as the case may be. Thus under the case of speculation, the managed floating exchange rate do not have much effect on the economy. **[4]**

LONG ANSWER TYPE QUESTIONS (6 marks each)

AI **Q. 1.** Fixed Exchange Rate is a necessary evil. Explain the statement by giving any three merits and three demerits of the system. C

Ans. The merits of Fixed Exchange Rate :

a) **Promotion of international trade:** As the exchange rates are fixed in the Fixed Exchange rate system, the importers and exporters feel confident about increasing the trade. This helps in the promotion of International Trade. **[1]**

b) **Incentives of foreign capital:** The foreign investors feel safe to invest in the domestic market. This brings in more of foreign capital which helps in the stabilisation of the economy and economic growth. **[1]**

c) **Acceleration in capital formation:** The foreign investment enables the country to get foreign capital by enabling it to invest in buying capital goods and also investing in the infrastructural development of the country. **[1]**

Demerits of Fixed Exchange Rates :

a) **Neglects National interest:** The fixed exchange rate system neglects national interest as the domestic currency is not pegged in accordance with the economic condition of the country. **[1]**

b) **Control over various sectors:** The government controls over the foreign exchange rate so indirectly it controls various sectors in the market. **[1]**

c) **Intervention of Central Bank:** The central bank changes the exchange rate as per its will in case of fixed exchange rate system. In order to substitute imports it can peg the domestic currency at a very low rate making imports expensive. **[1]**

Q. 2. Give the arguments in favour of and against the flexible exchange rate system. U

Ans. Merits of Flexible Exchange Rate System :

(1) Simple system: The exchange rate is determined by the market forces, so it is not to be calculated and fixed by the central bank. **[1]**

(2) Continuous adjustment: The foreign exchange requires continuous adjustments making it show the true economic condition of the economy. **[1]**

(3) Efficient utilization of resources: The resources can be utilised efficiently in order to affect the foreign trade especially imports. **[1]**

Demerits of Flexible Exchange Rate System :

a) **Bad effects of less elasticity:** If the imports are of less elastic demand, it will create a problem of deficit balance of trade as the imports will increase in value. **[1]**

b) **Creates uncertainty:** The exchange rate can change anytime leading to uncertainty in the minds of the importers and exporters regarding the exchange rate to be used at the time of trade. **[1]**

c) **Instability in international trade:** The international trade will be unstable as due to the uncertainty in the exchange rate changes. **[1]**

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