Correspondingly, the country) is also made the

Correspondingly, capital account convertibility covers payments in foreign currency relating to transactions on capital account. Capital account convertibility may, however, be only partial, i. e. restricted to some specified types of capital transactions. For example, in almost all cases, authorities try to debar speculative transactions. A policy of restricted convertibility is pursued when, in the judgement of monetary authorities, stock of foreign exchange reserves with them is insufficient to bear a sudden and large-scale outflow of capital funds; more so when there is also the risk of speculative outflows.

2. Intervention Meaning: Intervention means entering of monetary authorities in foreign exchange market either as buyers or as sellers for the purpose of preventing or reducing volatility (or one-sided drift) of exchange rate. It is an application of the principle of " buffer stocks" to counteract the volatility of a price.

**Precondition:**

Obviously, a successful intervention is possible only when the authorities have " adequate" foreign exchange reserves, and when they are ready to use them for achieving exchange rate stability. Note that " adequacy" of exchange reserves is a relative term, and its assessment varies with the " perception" of their possible need. This perception is also influenced by the scope for borrowing in the foreign exchange market, and the extent to which exchange rate stability is considered desirable. 3.

Exchange Control: In case ordinary intervention fails to impart necessary stability to the exchange rate, and there is a risk of some destabilising changes in it, the authorities may resort to what is termed “ exchange control”.

**Meaning:**

It is a system of total absence of convertibility, under which no payment in foreign currency is allowed without prior permission of the designated authority. Normally, for effective management of the system, the monetary authority (usually the central bank of the country) is also made the custodian of country’s foreign exchange reserves. All receipts of foreign exchange by the residents of the country are “ sold” to and deposited with the central bank, and all payments in foreign currency are made by the central bank on behalf of the resident payers. For example, right from its inception, RBI has been the custodian of our official foreign exchange reserves. When Second World War started, it was also entrusted with the task of exchange control, and this arrangement continues till today. For several decades, RBI pursued the dual policy of exchange control and (because of “ insufficient” foreign exchange reserves) non-convertibility of rupee.

(Of late, it has followed a policy of a phased relaxation of exchange control, as foreign exchange position has eased considerably over the last few years).

**Evaluation of Exchange Control:**

Merits: i. It is an effective tool for ensuring stability of forex reserves and avoiding external payments crises. ii. Exchange control enables a country to manage its balance of payments even with limited foreign exchange reserves, by conserving, husbanding and closely monitoring forex position.

iii.

If implemented properly, it can be an effective tool for preventing " unnecessary" imports, and for providing effective protection to domestic industries. Demerits: i. By its very nature, a successful exchange control strategy has the effect of red-cing volume and value of international trade.

ii. It has an inherent tendency to create and sustain a situation of' fundamental disequilibrium' and, therefore, encourages black marketing in foreign exchange. iii. Like other official controls, it breeds inefficiency, delays and corruption. iv. The authorities managing exchange control become the de facto policy makers whose decisions lack objectivity.

v. It has its own resource cost for the country because the authorities have to set up and maintain an appropriate administrative machinery. vi. The basic justification for having an exchange control lies in " insufficiency" of foreign exchange reserves. But the very practice of exchange control restricts expansion of trade and helps in maintaining the scarcity of foreign exchange reserves. vii.

Procedural hurdles and delays are inherent in an officially regulated set up. Traders cannot take advantage of changing events in the exchange market. viii. Exchange control has the effect of discouraging direct foreign investment and other forms of capital inflow because of difficulties in outward remittance of foreign exchange.

ix. Like any state control, exchange control also creates vested interests, and it is inherently inequitable because of its selective use by the administration.

4. Vehicle Currency: A currency (such as the US dollar and British Pound) may acquire the status of an international currency (also termed a vehicle currency). A vehicle currency is the one which is accepted by payees irrespective of the country where they want to spend it.

Each payee accepts it in the belief that other payees in the foreign exchange market are also eager to do so; and all of them believe that its country of origin has an inherently strong economy. In other words, a vehicle currency is the one which is widely used for financing international transactions; “ it is highly liquid”. It is also for this reason that several countries want that their “ financial claims” upon rest of the world should be denominated in one or more vehicle currencies. That way, these “ financial claims” may be either (i) balances in vehicle currencies themselves, or (ii) other financial assets which are convertible (payable) in these vehicle currencies.

Accordingly, these “ financial claims” are termed “ foreign exchange reserves.” These reserves are said to be “ parked” (that is, kept) in these “ financial claims”. Thus, these reserves are “ parked” in the form of bank deposits, balances with the foreign central banks, and investments in other financial assets. Over the years, trading in foreign exchange has assumed huge volumes. Several causal forces have contributed to this phenomenon including voluminous expansion in world trade and investment flows, world-wide growth in the financial sector, and speculative movement of floating funds.