This rate; and for that purpose they

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This is because the monetary standards, trading practices, and market structures of the trading countries are such that, even with free operation of market forces, it remains tightly anchored and cannot change (except within very narrow limits; and that too with self-reversal features). This situation holds under gold standard. Here, rate of exchange is automatically fixed at mint-parity, and is variable only within a narrow band determined by the gold points.

Situation II: Authorities do not allow a change in exchange rate; and for that purpose they exercise necessary control and regulation. This situation holds under a paper standard. Here, rate of exchange has to be maintained through direct regulation and/or intervention, and cannot be left to market forces. In this case, the authorities choose a ‘ par value’ of the domestic currency (in terms of some other currency, or in terms of an abstract unit such as the SDR) and then maintain it by whatever means they can.

It is assumed here that the monetary authorities are committed to maintaining the fidelity of exchange rate and have sufficient legal authority to do so. There are two broad paths pursued by the monetary authorities for this purpose.

(i) Path One:

Exchange control: If the authorities come to the conclusion that they do not have “ sufficient” foreign exchange reserves to successfully intervene and maintain the rate of exchange in alternative eventualities, they may resort to the technique of “ exchange control”. It would be recalled that it is regulatory system in which, (a) Inflow and outflow of foreign exchange are

effectively controlled, (b) No payment in a foreign currency is allowed without the prior permission of the monetary authorities, and (c) All receipts of foreign exchange must be handed over to the same authorities. In India, for example, RBI was entrusted with the task of exchange control when Second World War began in 1939.

(ii) Path Two:

Intervention: If, in their assessment, they have " sufficient" foreign exchange reserves to ensure successful intervention in the foreign exchange market, the monetary authorities ensure fidelity of rate of exchange (within very narrow limits) through intervention that is, through requisite buying and selling of domestic currency against foreign exchange.