

Managed float
exchange rate regime
is followed by india
economics essay



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In finance, an exchange rate also known as the foreign-exchange rate, forex rate or FX rate between two currencies is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country's currency in terms of another currency.

For example, an interbank exchange rate of 91 Japanese yen (JPY, ¥) to the United States dollar (US\$) means that ¥91 will be exchanged for each US\$1 or that US\$1 will be exchanged for each ¥91.

Exchange rates are determined in the foreign exchange market, which is open to a wide range of different types of buyers and sellers where currency trading is continuous.

Meaning of Managed Float:

Managed float regime is the current international financial environment in which exchange rates fluctuate from day to day, but central banks attempt to influence their countries' exchange rates by buying and selling currencies. It is also known as a DIRTY FLOAT.

In an increasingly integrated world economy, the currency rates impact any given country's economy through the trade balance. In this aspect, almost all currencies are managed since central banks or Governments intervene to influence the value of their currencies. In most instances, the intervention aspect of a dirty float system is meant to act as a buffer against an external economic shock before its effects become truly disruptive to the domestic economy.

“ MANAGED FLOAT EXCHANGE RATE REGIME IS FOLLOWED BY INDIA”

Meaning of Fixed Exchange rate:

A fixed exchange rate, sometimes called a pegged exchange rate, is also referred to as the Tag of particular Rate, which is a type of exchange rate regime where a currency's value is fixed against the value of another single currency or to a basket of other currencies, or to another measure of value, such as gold.

A fixed exchange rate is usually used to stabilize the value of a currency against the currency it is pegged to. This makes trade and investments between the two countries easier and more predictable and is especially useful for small economies in which external trade forms a large part of their GDP.

It can also be used as a means to control inflation. However, as the reference value rises and falls, so does the currency pegged to it. In addition, according to the Mundell-Fleming model, with perfect capital mobility, a fixed exchange rate prevents a government from using domestic monetary policy in order to achieve macroeconomic stability.

Meaning of Floating Exchange rate:

A country's exchange rate regime where its currency is set by the foreign-exchange market through supply and demand for that particular currency relative to other currencies. Thus, floating exchange rates change freely and are determined by trading in the forex market.

In some instances, if a currency value moves in any one direction at a rapid and sustained rate, central banks intervene by buying and selling its own

currency reserves (i. e. Federal Reserve in the U. S.) in the foreign-exchange market in order to stabilize the local currency. However, central banks are reluctant to intervene, unless absolutely necessary, in a floating regime.

Meaning of Crawling Peg:

A system of exchange rate adjustment in which a currency with a fixed exchange rate is allowed to fluctuate within a band of rates. The par value of the stated currency is also adjusted frequently due to market factors such as inflation. This gradual shift of the currency's par value is done as an alternative to a sudden and significant devaluation of the currency.

For example, in the 1990s, Mexico had fixed its peso with the U. S. dollar. However, due to the significant inflation in Mexico, as compared to the U. S., it was evident that the peso would need to be severely devalued. Because a rapid devaluation would create instability, Mexico put into place a crawling peg exchange rate adjustment system, and the peso was slowly devalued toward a more appropriate exchange rate.

Meaning of Currency Crises:

A currency crisis, which is also called a balance-of-payments crisis, is a sudden devaluation of a currency caused by chronic balance-of-payments deficits which usually ends in a speculative attack in the foreign exchange market. It occurs when the value of a currency changes quickly, undermining its ability to serve as a medium of exchange or a store of value. Currency crises usually affect fixed exchange rate regimes, rather than floating regimes.

A currency crisis is a type of financial crisis, and is often associated with a real economic crisis. Currency crises can be especially destructive to small open economies or bigger, but not sufficiently stable ones.

Governments often take on the role of fending off such attacks by satisfying the excess demand for a given currency using the country's own currency reserves or its foreign reserves (usually in the United States dollar, Euro or Pound sterling).

Reason Behind Depreciation of Rupee:

Foreign Funds Outflow

It is the major concern of Indian economy now. Because of the global uncertainty and various economy crisis like Europe sovereign debt problem, US economy problem, etc leads to search for the safe heaven among the investors. They are quickly pulling out the money from Indian market and investing in any other safe investments like Gold or US dollar.

Political Uncertainty and Corruption

This is one of the major factors for any country to stabilize the economy. In India, last one year we are seeing the series of corruptions and there is no good news from the ruling party (Congress) about the economic reforms and lot of agitation among the citizens including the veteran Gandhian Anna Hazare's campaign of Fight for Second Freedom which took attention from global media. India needs political change to gain confidence among the investors.

Stock markets performance

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Indian stock exchanges are highly depended and dominated by foreign investors. When the economy is doing well and stock markets are in better conditions than other countries' bourses, foreign investors will be more eager to invest here than anywhere else. They need rupee to invest in India so the demand is higher what results in higher value of Indian currency. But if they are pulling the money out from Indian markets, they are selling rupees that results in rupee's fall in value. Indian markets are in worse condition now than 1 year before and investors are having smaller real returns. Global sentiments after US downgrade and Euro zone crisis lead the overseas investors to sell in India and buy US Dollars. USD is considered now the safest currency in the world as gold prices are very high and many investors are worried that it's a bubble. So the higher demand in USD also causes the rupee depreciation.

Inflation

Another reason is inflation, which is very high in India now. High inflation causes decrease in the purchasing power against other currencies. This also results in Indian currency decrease.

Current account deficit

Current account deficit happened when a country's total import is higher than the total exports. This makes the country, a net debtor to the rest of the world. A high deficit indicates that country is spending more money outside than it's earning inside. This is not good for the country because, then the country needs to buy more foreign currency. More demand for the foreign

currency will again results in depreciation of the country's currency. Actual India's current account deficit is higher than the expected.

Country's affairs

Last year, there were lots of corruption issues. It is not that corruption was not present earlier but is high ticket now and more and more VIPs are going to prison daily. Nobody knows where it will finish. The parliament is not able to transact any significant business and reforms occupy a back seat in the agenda. The Anna Hazare's campaign against corruption took the attention of the global media, which affected negatively foreign investors' sentiments.

RBI interventions

RBI will intervene because a stable rupee is necessary for the systematic growth of the economy. A depreciating rupee will harm oil marketing companies and other import oriented businesses. This may however help the software companies, like Infosys and Wipro, and other exporters, who get their payment in dollars.

RBI is observing and will interfere to stabilize the currency value. In case of depreciation, RBI sells foreign currency from the reserve and this will help in arresting the fall of rupee to some degree.

Steps Taken By RBI to Control Depreciation of Rupee:

The central bank directed exporters to convert up to 50% of their foreign currency holding with banks into rupee balances within a fortnight, a move that will bring at least \$2. 5 billion into the market, lending support to the

rupee. Exporters were earlier permitted to keep 100% of their foreign currency earnings with banks in an Exchange Earner's Foreign Currency (EEFC) account. The balance outstanding in this account is about \$5 billion.

EEFC account holders will be permitted to access the market for purchasing foreign exchange only after using up all the money in their accounts. That means they wouldn't be able to hold their foreign exchange earnings and wait for a favorable exchange rate at which to sell the money.

RBI took steps to encourage more dollar flows into the country by increasing rates on foreign currency non-resident accounts and giving banks the flexibility to raise overseas funds at any cost to lend to exporters.

Graphical Trend of Dollar Rupee For June July August 2012:

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