UNIT 28 FOREIGN EXCHANGE STABILITY AND RELATED ISSUES

Structure

28.0 OBJECTIVES

After going through this unit, learners will be able to:

- explain the concept of foreign exchange stability;
- identify the key issues related to foreign exchange stability; and
- suggest measures to achieve foreign exchange stability.

28.1 CONCEPT OF FOREIGN EXCHANGE STABILITY

Foreign exchange stability refers to the consistency and predictability of exchange rates between different currencies. Alternatively, foreign exchange stability, also known as exchange rate stability, refers to a situation in which the currency of an economy maintains a relatively consistent or predictable value over other foreign currencies over some time. Exchange rate stability is a desirable goal for many countries and has several important implications for their economies and international trade. Foreign exchange stability is a key concern for governments, businesses, and investors, as it affects the cost of imports and exports, the competitiveness of industries, and the overall economic health of a country. Maintaining a stable exchange rate is often a delicate balancing act, requiring careful policy choices and international cooperation to mitigate risks and support economic growth.

28.2 BASIC CONCEPTS

Let us discuss certain basic concepts related to exchange rate stability.

28.2.1 Meaning of Exchange Rate

Many times, we hear through the mass media such as Zee Business, Bloomberg TV, CNN, CNBC, BBC or print media such as The Times of India, Business Line, etc. that the US dollar has appreciated against the Indian rupee or Indian rupee has become stronger against the US dollar, Sterling Pound, Japanese Yen, etc. What does it mean? The media frequently discusses the ups and downs in exchange rates. An exchange rate means the price of the currency of a country like the Indian rupee in terms of the currency of another country like the US dollar. So, when the media report that the exchange rate between India and the US is ₹ 83.17/$1, then it means that one US dollar is equal to ₹ 83.17. In other words, it means that one US dollar can buy 83.17 Indian rupees. As the dollar appreciates against the Indian rupee, then one dollar can buy more Indian rupees or as the dollar depreciates against the Indian rupee, then one dollar can buy less Indian rupees. Media may report an exchange rate in direct and indirect quotes the meaning of which are given below.

A direct quote measures how many units of domestic currency can be bought by one unit of a foreign currency while an **Indirect quote** measures how many units of foreign currency can be bought by one unit of domestic currency. Thus, the direct quote between the Indian rupee (domestic currency) and the US dollar (foreign currency) can be expressed as follows:

$1 = ₹ 83.17

The indirect quote between the Indian rupee (domestic currency) and the US dollar (foreign currency) can be expressed as follows:

₹ 1= $ 0.0120

28.2.2 Exchange Rate Systems

a) **Fixed Exchange Rate**: Under this regime, a country's currency is pegged to another currency or a fixed value like gold. This provides stability but can be challenging to maintain in the long run. Under this system, the exchange rate is determined by the central bank (e.g., RBI in India). The exchange rate so fixed is also called **the official exchange** rate. The central bank ensures that the exchange rate should not go beyond or fall below the exchange rate fixed. To understand how the fixed exchange rate system works, let us examine Fig. 28.1. We assume that the Reserve Bank of India (RBI) desires to keep the exchange rate between the US dollar ($) and Indian rupee (₹) fixed at ₹ 50/$. But the equilibrium exchange rate in the foreign exchange market the exchange rate is ₹ 60/$ as determined by the intersection of demand curve D and

supply curve S_1 at point E_1, then to bring the exchange rate to the desired level of ₹ 50/$, the RBI will have to sell the dollars equal to Q_1Q_2 so that the supply can increase from S_1 to S_2 intersecting demand curve D at point E_2. Thus, we have a new equilibrium point E_2 at which the exchange rate reaches to the desired level of ₹ 50/$. Now the question is how does the central bank sell Q_1Q_2 dollars? The answer is the arbitration process. In the arbitrage process, there is a person, known as an arbitrageur**,** who can buy one dollar from the RBI by paying ₹ 50 and then sell the same dollar in the foreign exchange market for ₹ 60 to earn a profit of ₹ 10 per dollar. Thus, an arbitrager can earn a total profit of ₹ 10 multiplied by Q_1Q_2. One point is also relevant here i.e., on selling Q_1Q_2 dollars the foreign exchange reserves held by RBI fall. Thus, when a currency (US dollar in the present case) is overvalued, then foreign exchange reserves fall if a fixed exchange rate system is adopted. If the equilibrium exchange rate in the foreign exchange market falls below the desired level, then the RBI can buy the required amount of dollars to bring it above. It will increase the foreign exchange reserves.

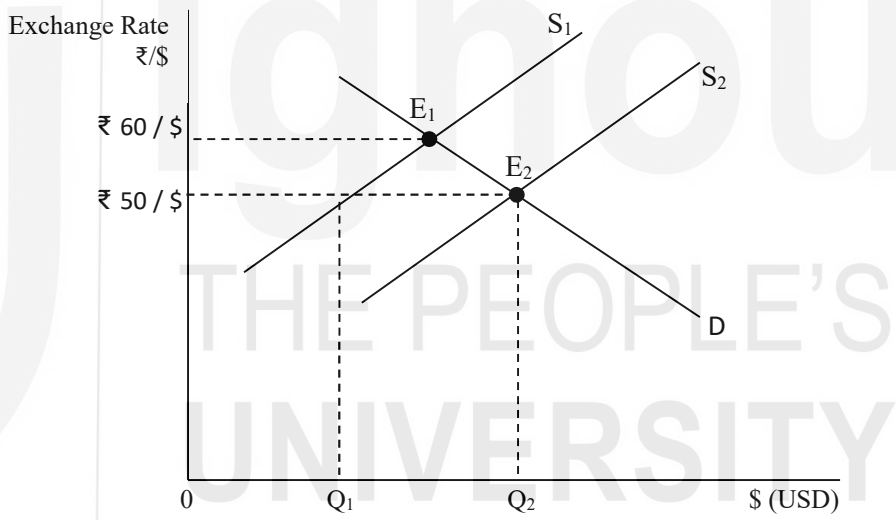

Fig. 28.1: Fixed Exchange Rate System

b) **Floating Exchange Rate**: In this regime, the exchange rate is determined by market forces, such as supply and demand. This allows for flexibility but can lead to volatility. Under this system, the exchange rate is determined based on the demand and supply of the foreign currency concerned. Alternatively, market forces of demand and supply for the foreign currency decide the equilibrium exchange rate. To understand this, consider the US dollar as a foreign currency against the Indian rupee, then the exchange rate between the US and India is determined by the demand for and supply of the US dollar. When the demand for the US dollar is equal to its supply, the corresponding exchange rate is known as the equilibrium exchange rate. It is evident that shifts in supply and demand affect the exchange rate and cause it to rise or fall. Let us understand the system through Fig. 28.2. In Fig. 28.2, D_1 denotes the demand for the US dollar and S_1 does the supply of the same. Both the curves are intersecting at the point E_1. Therefore, point

E_1 is the equilibrium point where the exchange rate is e_1 called the equilibrium exchange rate. Now, suppose that the supply of the US dollar increases causing the supply curve to shift S_2. S_2 intersects D_1 at E_2. Thus, the new equilibrium exchange rate is e_2. Thus, we conclude that an increase in supply with constant demand leads fall in the exchange rate. Opposite will happen when the supply falls with constant demand. Now suppose that due to some reason, the demand for the US dollars increases to D_2 with constant supply at S_1. As a result, a new equilibrium exchange rate e_3 is obtained. Therefore, an increase in demand with constant supply leads increase in the exchange rate. Opposite will happen if the demand falls with constant supply. However, demand and supply both can change simultaneously, accordingly exchange rate too fluctuates.

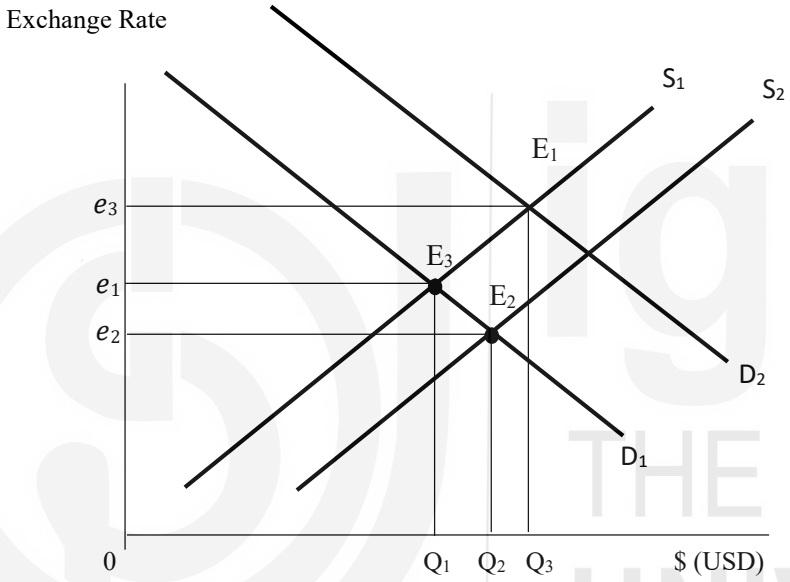

Fig. 28.2: Floating Exchange Rate System

28.2.3 Factors Affecting Demand for Foreign Exchange

Some of the factors that affect demand for foreign exchange are discussed as follows:

1) To pay import bills

To import goods and services from abroad our country needs foreign currency. So, if an Indian trader wants to import cars from the US, then he will demand US dollars to pay for the cars. Similarly, if Air India wants to buy some new airbuses from the UK, then it will demand Sterling Pound to pay for the air buses. Thus, imports create demand for foreign currencies.

2) To repay international loans

Indian corporations or governments demand foreign currency to repay the loans taken from foreign countries. Thus, repayment of international loans creates demand for foreign exchange.

3) Arbitrage purpose

Suppose, there are two foreign exchange markets X and Y in which the exchange rates between the Indian rupee and the US dollar are ₹ 50 per dollar and ₹ 55 per dollar respectively. Then, a person who wants to gain from these exchange rate differences will buy the US dollars from X and sell the same in Y and will earn ₹ 5 per dollar as profit. This is known as the arbitrage process. This is obvious that the demand for the US dollar increases in market X.

4) Speculation

Speculation means the opportunity for profit due to the difference between the prices of a good/share/currency etc. at two points in time. So, if we expect that the US dollar will appreciate in future, it means the US dollar is relatively cheaper now, therefore, one may buy or demand US dollars today and sell the same in future at a higher price can earn a profit.

5) To give gifts, and grants to foreign countries

Indian residents or governments may decide to give gifts, grants etc. for some purposes. To do so they will demand foreign currency. For example, the Indian government may decide to gift 10 million US dollars; the government will demand 10 million US dollars.

6) Investment in foreign countries

Indian investors may decide to invest in foreign countries. For example, if TATA group decides to take over Jaguar (a car company in Great Britain), the latter will demand Sterling Pound for payment of the consideration. Similarly, if a resident of India wants to buy equity shares of a US company, then (s)he will demand US dollars to do so.

7) To visit foreign countries

Indian residents will demand Sterling Pound, US dollars, Australian dollars, Canadian dollars etc. if they want to visit Great Britain, the US, Australia, and Canada respectively. The purpose of the visit may be tourism, higher study, etc.

8) To remit the money

Foreigners may be working in India and they will earn in Indian currency. To remit these earnings to their parents, spouses, relatives etc. in their home countries, they will demand foreign currencies.

28.2.4 Factors Affecting Supply of Foreign Exchange

1) Receipts of exports

Exports of goods and services are one the major sources of foreign exchange supply. So, if an Indian car company exports some cars to the US dollars will move to India.

2) Repayment of international loans

Indian corporations or governments might have decided to give loans to other countries, then their repayments will bring foreign exchange.

3) Arbitrage purpose

Suppose, there are two foreign exchange markets X and Y in which the exchange rates between the Indian rupee and the US dollar are ₹ 50 per dollar and ₹ 55 per dollar respectively. Then, a person who wants to gain from these exchange rate differences will buy the US dollars from X and sell the same in Y and will earn ₹ 5 per dollar as profit. This is known as the **arbitrage** process. It is obvious that the supply of dollars increases in market Y.

4) Speculation

Speculation means the opportunity for profit due to the difference between the prices of goods/ stocks/ currency, etc. at two points in time. So, if we expect that the US Dollar will depreciate in future, it means the US Dollar is relatively expensive now, therefore, one may sell US Dollars today to escape from future loss.

5) Gifts and grants from foreign countries

Foreign residents or governments may decide to give gifts, grants etc. to India, for some purposes. As a result, foreign exchange will move to India.

6) Investments from foreign countries

Foreign investment in a domestic company can lead to an increase in the supply of foreign exchange in several ways. Foreign exchange refers to the currency of a foreign country, and it is used to facilitate international trade and investment. When foreign investors invest in a domestic company, they often need to acquire the domestic currency to make their investment.

7) Visiting the home country (i.e., India, in our Case)

Foreign residents or NRIs may decide to visit India for tourism, higher study, or other purposes. Therefore, they will need Indian currency to pay in India. Hence, they will exchange the currencies against the Indian rupees. In this way, the foreign exchange reserves of India will increase.

8) Foreign remittances

Indian residents or Indian corporations may be working or operating outside India and they will earn in foreign currencies. To remit these earnings to their parents, spouses, relatives etc. in India, they will

demand Indian currency in exchange for the foreign currencies available to them.

Check Your Progress 1

1) What is the need for foreign exchange stability in a country?

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2) Briefly describe various factors affecting the Supply of Foreign Exchange.

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3) Compare fixed exchange rate system with floating exchange rate system.

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28.3 ISSUES IN FOREIGN EXCHANGE STABILITY

Here are some key aspects and related issues in foreign exchange stability:

1) Managed or Dirty Floating

A "managed float," also referred to as a "dirty float," is a regime for exchange rates where the exchange rate is neither fully set nor completely free. Instead, central bank intervention maintains the currency's value within a range relative to another currency or a basket of currencies. Some countries are accused of manipulating their exchange rates to gain an unfair trade advantage. This can lead to international tensions and trade disputes. In today's global economy, currency exchange rates play a crucial role in shaping a country's economic performance. Nearly all economies actively manage their currencies, with central banks or governments frequently intervening to control their values. According to data from the International Monetary Fund (IMF) in 2014[1], 82 countries and regions, representing 43 per cent of economies, employed a managed float system, making it the most prevalent exchange rate regime.

[1]https://asia.nikkei.com/Markets/Currencies/IMF-finds-more-countries-adopting-managed-floating-exchange-rate-system

2) Exchange Rate Policy

The exchange rate policy of an economy can be influenced by its economic goals. For example, a country may pursue a strong currency policy to control inflation or a weak currency policy to boost exports. For example,

> ……in the 1990s, India's economy was experiencing hardship. 39% of the money the government was collecting at the time went toward paying interest. After cutting its fiscal deficit to 7.8% of GDP, India faced the risk of being branded a defaulter on the global stage. A devaluation of the Indian rupee was necessary in light of this problem. The process of devaluation involves a country lowering the value of its currency on the global market while maintaining its intrinsic value. Similar measures were taken by India to increase the cost of its imports and decrease the price of its exports.
>
> ***Source**: https://www.bookmyforex.com/blog/1-usd-inr-1947-till-now/*

3) Parallel Foreign Exchange Systems

Parallel foreign exchange systems are found in many developing countries, where they combine a market-driven exchange rate that primarily applies to financial transactions, and sometimes a portion of trade transactions, alongside one or more fixed exchange rates. These arrangements are often implemented in response to a balance of payments crisis. In one scenario, governments establish a legal parallel or dual foreign exchange market for financial transactions. This move is aimed at mitigating the immediate impact of a depreciation in the exchange rate on domestic prices while retaining some level of control over capital outflows and international reserves. In another scenario, strict foreign exchange controls limit access to official markets, leading to the emergence of an illicit parallel market. As the authorities respond to a worsening balance of payments situation by tightening and expanding exchange controls, the illicit market gains prominence. Strong limitations that have led to external imbalances and the growth of a substantial parallel market where the currency currently trades at nearly a 60 per cent premium characterize Burundi's foreign exchange market. One of the authorities' main short-term goals going ahead is to stabilize the exchange rate and lessen these distortions[2]. Informal trade (i.e., parallel foreign exchange market) in South Asia was 50 per cent of formal trade between 1993 and 2005[3].

[2]www.elibrary.imf.org
[3] https://blogs.worldbank.org/endpovertyinsouthasia/capital-controls-and-parallel-exchange-rates-south-asia

4) Political Instability

Political stability affects foreign exchange rates significantly and raises demand for a currency. Switzerland, for example, is renowned for its political stability, adherence to neutrality, and avoidance of international confrontations. Because of this, the Swiss franc is seen as a haven in foreign exchange trading and is frequently used to offset currency risk. Conversely, political unrest, coops, and protests destabilize the economy and devalue the local currency. As a result, there is less demand for and more risk associated with keeping the relevant domestic currency.

5) Trade Balances

Consider the distribution of national output as

$$Y = C^d + I^d + G^d + X$$

Where,

$Y =$ National output

$C^d =$ Consumption of domestically made goods and services

$I^d =$ Investment in domestically made goods and services

$G^d =$ Government expenditure on domestically made goods and services

$X =$ Exports of domestically made goods and services

We know that in the world of globalization or the case of an open economy, people do not consume only domestically produced services, investment is not restricted to domestic goods and services only and similarly, government purchases are not limited to domestic goods and services only. Therefore, we can say that

$$C = C^d + C^F$$

$$I = I^d + I^F$$

$$G = G^d + G^F$$

where the super-script F on C, I and G show the consumption of, investment in and government expenditure on foreign goods and services respectively.

Now, the national income identity can be re-written as follows:

$$Y = C - C^F + I - I^F + G - G^F + X$$

$$Y = C + I + G + X - C^F - I^F - G^F$$

$$Y = C + I + G + X - (C^F + I^F + G^F)$$

Since $C^F + I^F + G^F$ means the total imports denoted by IM and therefore

$$Y = C + I + G + X - IM$$

The difference X – IM is called net exports (NX) and many times called trade balance and therefore national income accounts identity in an open economy becomes

$$Y = C + I + G + NX$$

$$NX = Y - (C + I + G)$$

Thus,

$$\text{Net exports} = \text{National output} - \text{Domestic spending}$$

Now, Consider the national income account identity again

$$Y = C + I + G + NX$$

$$Y - C - G = I + NX$$

The left-hand side of the equation is called national saving (S) and therefore

$$S = I + NX$$

$$S - I = NX$$

Thus, the net exports are equal to the excess of savings over investments. The difference between savings and investment is called net capital outflow (or net foreign investment) because the difference shows the flow capital i.e., if S is greater than I, then the excess amount is invested in the rest of the world which causes the outflow of the capital from the domestic land and if S is less than I, then the shortage is met from the rest of the world which causes inflow of the capital. Thus, positive NX means net capital outflow which means there is trade surplus and negative NX means net capital inflow which means trade deficit. In this way, net exports are financed by the net capital outflow. Now, we consider a small open economy in case of which this is assumed that the domestic interest denoted by r* is determined by the world interest rate denoted by r. Thus,

$r^* = r$

We know that the investment is a function of interest rate and therefore we have

$$I = I(r)$$

Further, since, S depends upon Y, C and G and Y is supposed to be constant because it is determined by the factors of production, G is

constant and C is a function of disposal income which is also determined by Y and therefore, the S becomes constant which is denoted by $\bar{S}$.

Hence,

$$\bar{S} - I(r^*) = NX$$

The last equation clearly shows that net exports or trade balance depends upon the world interest rate r* and $\bar{S}$.

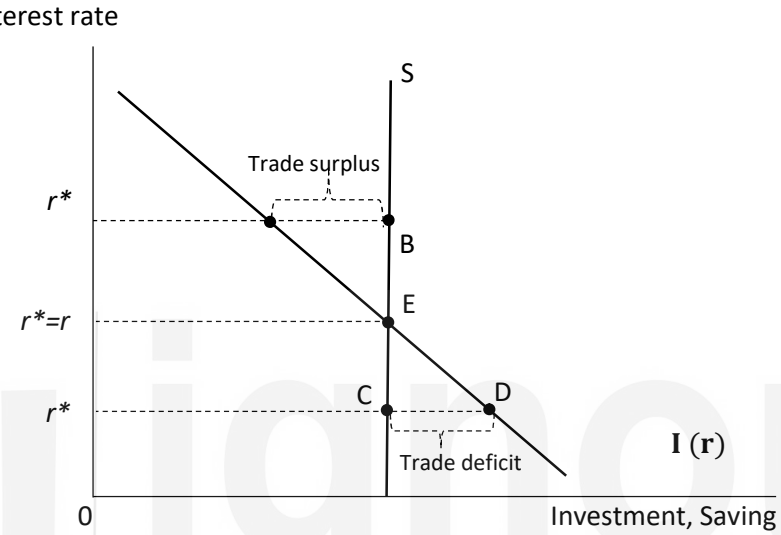

Fig. 28.3: Relationship between Real Interest Rate, Saving and Investment

Fig. 28.3 shows that with constant saving line and downward-sloping investment function determine the interest rate r if the economy is closed and it is in equilibrium at E. But when the economy is open and the world interest rate r* > r, then there is a trade surplus equal to AB and when r* < r, there is a trade deficit equal to CD. When r* = r, then there is zero trade balance. Thus, in the case of a small open economy, the world interest rate determines the trade balance. Now, we see the relationship between the real exchange rate and the net export

We know that

Real Exchange Rate

$$= \text{Nominal Exchange Rate} \times \frac{\text{Price level in the domestic country}}{\text{price level in the foreign country}}$$

Let

$$\alpha = \text{Real exchange rate}$$

$$e = \text{Nominal exchange rate}$$

And

$$\theta = \frac{\text{Price level in the domestic country}}{\text{Price level in the foreign country}}$$

Therefore,

$$\alpha = e \times \theta$$

Now, for a given value of e, α will rise if θ rises or vice versa. Therefore, when the real exchange rate increases, then it means foreign goods have become relatively inexpensive and it will be beneficial to buy goods from abroad. As a result, imports from the home country will increase. At the same time, foreigners will not buy from the domestic country due to low relatively expensive goods as compared to their own country. As a result, the exports of the home country will decrease. In this way, the real exchange rate causes imports to increase and exports to fall. Overall, net exports fall. Hence, there is a negative relationship between the net exports and the real exchange rate. Mathematically, it can be said that net export is a negative function of the real exchange rate. Symbolically,

$$NX = f(\theta)$$

Graphically,

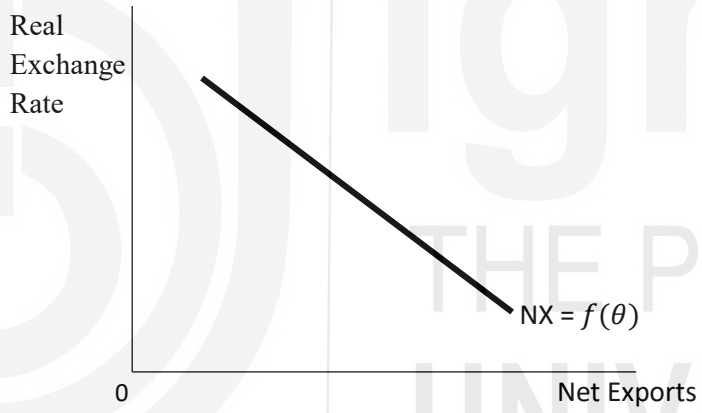

Fig. 28.4: Relationship between Real Interest Rate and Net Exports

Thus, the relative worth of currencies is shaped by the demand for them, which, in turn, is heavily influenced by trade dynamics. When a country consistently exports more than it imports, resulting in a trade surplus, there is a strong demand for its products and, consequently, its currency. According to the basic principles of supply and demand, high demand leads to higher prices and an increase in the value of the currency, which appreciates.

Conversely, when a country imports more than it exports, creating a trade deficit, the demand for its currency is relatively weaker. As a result, currency prices tend to decrease. In the context of currency, this means the currency depreciates or loses value.

6) Inflation and Interest Rates

Inflation and interest rates are closely intertwined, and their relationship can significantly affect exchange rates. Countries strive to strike a

delicate balance between these two factors, but managing this interplay is often intricate. Lower interest rates stimulate consumer spending and foster economic growth, typically exerting a positive impact on a country's currency value. However, if consumer spending surges to the extent that it outpaces supply, it can lead to inflation, which isn't necessarily a negative outcome. Nonetheless, lower interest rates typically do not attract foreign investment. On the other hand, higher interest rates tend to lure foreign investors, which, in turn, heightens the demand for a country's currency. Finding the right equilibrium in this regard can be challenging, and the effect on a country's exchange rate can be complex. In general, when inflation is high, it tends to weaken a currency as its purchasing power diminishes. This makes goods more expensive and can discourage investors. Conversely, when inflation is low, more capital flows into the country, bolstering the currency's value due to increased purchasing power and thus improving its exchange rate. In this regard, you should recall the IS-LM model in a closed economy and the **Mundell-Fleming Model** in an open economy.

7) Global Events

Events like financial crises, geopolitical tensions, and economic downturns in major economies can significantly impact exchange rates and disrupt stability. 2008 saw a severe decline in global currency values. The global financial crisis was a global issue that affected the Indian economy in a ripple fashion. After the Great Depression, this was the most serious crisis. Covid-19 caused an enormous crisis in 2020 that affected the entire planet. Every country's economy had difficulties as a result of the pandemic, including India. The value of the Indian rupee experienced fluctuation. The country did, however, recover more quickly than expected thanks to its fortitude and aggressive initiatives. Chortane and Pandey (2022)[4] conducted an event study to find the impact of the Russia-Ukraine war on the value of global currencies against the US dollar. The study shows that the conflict between Russia and Ukraine affected the value of all major world currencies negatively, but a region-by-region analysis reveals that the currencies of the Pacific region significantly appreciated, the currencies of the Middle East and Africa (ME&A) are negligible, and European currencies (especially the Russian rouble, Czech koruna, and Polish zloty) depreciated against the USD. Further, the study shows how the currencies of Poland and the Czech Republic have depreciated considerably compared to the US dollar as a result of the financial and economic restrictions placed on Russia and their closeness to the conflict zone. Moreover, the Pan-American, European (especially the Polish zloty and the Russian rouble), and

[4]Chortane, S. G., & Pandey, D. K. (2022). Does the Russia-Ukraine war lead to currency asymmetries? A US dollar tale. The Journal of Economic Asymmetries, 26, Article e00265. https://doi.org/10.1016/j.jeca.2022.e00265

Middle Eastern and African (ME&A) currencies have all benefited greatly from the Russian Central Bank's announcement to tie the rouble with gold.

28.4 MEASURES TO MAINTAIN FOREIGN EXCHANGE STABILITY

Here are certain ways to maintain foreign exchange stability in an economy.

1) **Central Bank Intervention**

   Central banks can use their foreign exchange reserves to buy or sell their currency in the foreign exchange market to influence its value. By doing so, they can mitigate excessive currency fluctuations and maintain stability. This is often done to counteract extreme currency appreciation or depreciation.

2) **Fixed Exchange Rate Systems**

   Some countries opt for fixed or pegged exchange rate systems where the value of their currency is fixed or pegged to another stable currency, such as the U.S. dollar or the euro. Maintaining this peg requires active central bank intervention and foreign reserves to ensure that the exchange rate remains stable. However, the fixed exchange rate system has its limitations.

3) **Managed Float**

   In a managed float system, exchange rates are allowed to fluctuate within a certain range, but central banks will intervene when the rate moves outside of that range to prevent extreme volatility.

4) **Fiscal and Monetary Policies**

   Governments can use fiscal and monetary policies to influence exchange rates indirectly. For example, interest rate adjustments can affect the attractiveness of a currency to foreign investors. Tightening or loosening monetary policy can influence exchange rates.

5) **Economic Reforms**

   Structural reforms in the economy, such as improving infrastructure, reducing trade barriers, and addressing fiscal deficits, can boost confidence in the currency and help maintain its stability.

6) **Exchange Rate Bands**

   Implementing an exchange rate band system can allow for some degree of fluctuation while preventing extreme movements. The central bank intervenes when the exchange rate reaches the upper or lower bounds of the band.

7) **Transparency and Communication**

Central banks and governments should communicate their exchange rate policies clearly to the public and financial markets. Transparency can help manage expectations and reduce uncertainty.

8) **Foreign Exchange Reserves**

Accumulating and maintaining foreign exchange reserves provides a financial buffer that can be used to stabilize the currency during periods of volatility. However, building and maintaining sufficient reserves can be expensive.

9) **International Cooperation**

Collaboration with other countries and international organizations can help stabilize exchange rates. This can include currency swap agreements, coordinated interventions, and harmonized policies.

You should note that the approach to maintaining foreign exchange stability can vary from one country to another based on their economic conditions, policy objectives, and the global economic environment. Additionally, exchange rate stability is not always the primary goal; some countries may prioritize other economic objectives, such as inflation control or economic growth, which can affect exchange rates.

Check Your Progress 2

1) Explain the relationship between Real interest rate, Saving and Investment.

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2) Describe the relationship between real interest rate and net exports.

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3) State some of the latest issues of foreign exchange stability.

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4) What are your suggestions for maintaining foreign exchange stability?

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28.5 LET US SUM UP

Foreign exchange stability refers to the ability of a country to maintain a relatively stable and predictable exchange rate for its currency in the foreign exchange market. In other words, it means that the value of a country's currency remains relatively constant over time, which can be important for economic and financial stability. Foreign exchange stability is essential for a country's economic well-being and international trade. Achieving and maintaining this stability involves a complex interplay of economic policies, market forces, and external factors. Countries strive to strike a balance that promotes growth, trade, and financial stability while avoiding excessive exchange rate volatility. Here are some key points related to foreign exchange stability and its related issues:

a) Exchange Rate Stability: Exchange rate stability implies that the value of a country's currency remains steady or experiences only gradual fluctuations about other currencies. This stability can make it easier for businesses, investors, and governments to plan for the future.

b) Economic Factors: Several economic factors can influence exchange rate stability, including inflation, interest rates, trade balances, and fiscal policies. A country with low inflation, stable interest rates, a trade surplus, and responsible fiscal policies is more likely to have a stable exchange rate.

c) Central Bank Interventions: Central banks often play a crucial role in maintaining exchange rate stability. They can buy or sell their currency in the foreign exchange market to influence its value. For example, if a country's currency is appreciating too rapidly, the central bank may intervene by selling its currency to increase its supply and decrease its value.

d) Fixed vs. Floating Exchange Rates: Countries can adopt different exchange rate systems. Some use fixed or pegged exchange rates, where the value of their currency is tied to a specific foreign currency (e.g., the US dollar). Others use floating exchange rates, which are determined by supply and demand in the foreign exchange market. Maintaining stability can be more challenging for countries with fixed exchange rates.

e) Speculation and Market Sentiment: Exchange rates are also influenced by speculation and market sentiment. Traders and investors make decisions based on their expectations of future exchange rate movements, which can sometimes lead to sharp and unpredictable fluctuations.

f) External Shocks: Events such as financial crises, geopolitical tensions including the war, or natural disasters can disrupt exchange rate stability. These external shocks may lead to sudden and significant currency depreciation or appreciation.

g) Currency Reserves: Accumulating foreign exchange reserves can help a country maintain exchange rate stability. These reserves can be used to intervene in the foreign exchange market when necessary. However, building and maintaining sufficient reserves can be expensive.

h) International Cooperation: Exchange rate stability is often a subject of international cooperation, especially within organizations like the International Monetary Fund (IMF). Countries may seek financial assistance or policy coordination to address exchange rate-related challenges.

i) Challenges of Overvaluation and Undervaluation: An overvalued currency (one that is too strong) can hurt a country's exports, while an undervalued currency (one that is too weak) can lead to inflation and discourage foreign investment. Striking the right balance is essential for stability.

To maintain the foreign exchange stability, the following measures can be adopted.

a) Central Bank Intervention: Central banks buy/sell currency to control value.

b) Fixed Exchange Rate: Currency pegged to a stable currency, needs intervention.

c) Managed Float: Exchange rates allowed to fluctuate within a range, intervened when extreme.

d) Forward Contracts/Options: Used for hedging currency risk, and stabilizing rates.

e) Fiscal/Monetary Policies: Adjusting interest rates influences currency attractiveness.

f) Economic Reforms: Structural changes boost currency confidence.

g) Exchange Rate Bands: Allow fluctuation within bounds, central bank intervenes at limits.

h) Transparency/Communication: Clear policies reduce uncertainty.

i) Foreign Exchange Reserves: Buffer for currency stabilization, costly to maintain.

j) International Cooperation: Collaborative efforts for exchange rate stability.

28.6 KEY WORDS

Foreign exchange stability : Consistency and predictability of exchange rates between different currencies.

Direct quote : It measures how many units of domestic currency can be bought by one unit of a foreign currency.

Indirect quote : It measures how many units of foreign currency can be bought by one unit of domestic currency.

Fixed Exchange Rate : Under this regime, a country's currency is pegged to another currency or a fixed value like gold.

Floating Exchange Rate : In this regime, the exchange rate is determined by market forces, such as supply and demand.

Managed float : is a regime for exchange rates where the exchange rate is neither fully set nor completely free.

28.7 SOME USEFUL BOOKS

Case, K. E. (2012). *Principles of Macroeconomics*. Prentice Hall.

Krugman, P. R. (2012). *International Economics: Theory & Policy* (9th ed.). Pearson Addison-Wesley.

Mankiw, N. G. (2009). *Macroeconomics* (7th ed.). Worth Publishers.

Stutz, F. P., & Warf, B. (2010). *The World Economy: Geography, Business, Development*. Pearson Education, Limited.

28.8 ANSWER / HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) It affects the cost of imports and exports, the competitiveness of industries, and the overall economic health of a country.

2) Receipts of exports, repayment of international loans, arbitrage purpose, speculation, gifts and grants from foreign countries, investments from foreign countries, and foreign remittances.

3) Refer to Sub-section 28.2.2

Check Your Progress 2

1) $\bar{S} - I(r^*) = NX$. Refer to section 28.3 for details.

2) Net export is a negative function of the real exchange rate. Symbolically, $NX = f(\theta)$

3) Managed or Dirty Floating, Exchange Rate Policy, Parallel Foreign Exchange Systems, Political Instability, Trade Balances, Inflation and Interest Rates, Global Events.

4) Central Bank Intervention, fixed Exchange Rate Systems, managed float, fiscal and monetary policies, economic reforms, exchange rate bands, transparency and communication, foreign exchange reserves, and international cooperation.

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