Fixed Exchange Rate System – Devaluation, Revaluation, Merits and Demerits

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Government or monetary authority determined exchange rate system by tying with other country currency.

A fixed exchange rate is a regime imposed by a government or central bank which ties the official exchange rate of the country's currency with the currency of another country or the gold price. A fixed exchange rate system has the aim of keeping the value of a currency within a narrow band. [https://cleartax.in/glossary/fixed-exchange-rate/]

Under this system, the exchange rate for the currency is fixed by the government. Thus, the government is responsible to maintain the stability of the exchange rate. Each country maintains the value of its currency in terms of some 'external standard' like gold, silver, another precious metal, or another country's currency. [https://www.geeksforgeeks.org/fixed-exchange-rate-system-meaning-methods-merits-and-demerits/]

Devaluation and Revaluation

Devaluation includes a reduction in the value of the domestic currency in terms of foreign currencies by the government. Under a fixed exchange rate system, the government undertakes devaluation when the exchange rate is increased.

Revaluation refers to an increase in the value of the domestic currency by the government.

Merits of Fixed Exchange Rate

1. Eliminate Uncertainty and Risk: In order to have orderly and steady growth in trade, it is essential to have stability in the exchange rate. If there is any change in the exchange rate it can cause problems to the plans of importers and exporters. Any fluctuation in the exchange rate may result in uncertain income for the exporters and cost for the importers. This kind of uncertainty is removed through a fixed exchange rate system.

2. Discourage Speculation: As the exchange rate under this system remains constant for quite a long time, people expect the rate to not change in the immediate future, which eliminates any kind of speculation in the foreign exchange market. Besides, it also discourages capital flight. If there are more fluctuations in the exchange rate, it increases the risk of capital flight as it encourages people to speculate. However, as the exchange

rate is fixed in this exchange rate system, the traders feel confident about their international payments.

3. Attracts Foreign Investment: If a country has a fixed exchange rate system, it may encourage foreigners to invest their money in that country. These foreign investments with multiplier effects result in the high economic growth of the country.

4. Anti-inflationary: The fixed exchange rate system is anti-inflationary in nature. It means that, if the exchange rate is allowed to fall, then the import goods tend to become dearer to people. Also, the high cost import goods results in inflation. Such situations are prevented by a fixed exchange rate system.

5. Prevents Depreciation of Currency: Poor developing countries usually face permanent BOP difficulties, and under these situations, if the exchange rate also changes, it can provoke the BOP crisis, such as, the home currency may continue to depreciate in terms of the currencies of other countries. This is prevented by a fixed exchange rate system.

6. Adoption of Responsible Macroeconomics Policies: If the exchange rate system of a country is stable/fixed, it prevents the government from adopting any kind of irresponsible macroeconomic policies such as currency devaluation, etc. Besides, with the help of a fixed exchange rate system, a country can pursue deflationary policies to tide over its BOP deficit without making any changes to its domestic policies.

Demerits of Fixed Exchange Rate System

1. Encourage Speculation: It is possible to have uncertainty and speculation under the fixed exchange rate system. If a country with a fixed exchange rate system faces a huge BOP deficit, then there is a possibility of speculation. If the speculators guess that the BOP deficit with continue to exist in the future too and the authorities may make a cut in the foreign exchange rate, then they will try to sell the domestic currency in the foreign exchange market. And, if this sale continues for a long time period, then the Central Bank will be forced to reduce the exchange rate.

In this situation, the speculators keep on purchasing the home currencies where the exchange rates have declined, allowing these people to earn a profit. An example of the effect of such speculation is the collapse of the Bretton Woods System of the IMF in 1971.

2. Bypass International Competitive Environment: Another disadvantage of the fixed exchange rate system is that it does not reflect any continuous change in the international competitive environment.

3. Adequacy of Foreign Exchange Reserves: To have an effective and stable exchange rate, it is essential to have the adequacy of holding foreign exchange reserves which is a difficult task for poor developing countries. Therefore, it is not an adequate exchange rate system for small and developing countries.

4. Sacrifice of Internal Objectives of Growth: In order to maintain and control the fixed exchange rate, a country has to sometimes sacrifice its internal problems and growth objectives.