M.A. IV Semester

Paper- Indian Foreign trade and International Institutions(401)

Foreign Exchange Control: Definition, Objectives & Methods

Dr. Kalpana Sharma

SOS in Economics,

Jiwaji University Gwalior

Definition of Foreign Exchange Control:

Foreign Exchange Control is a method of state intervention in the imports and exports of the country, so that the adverse balance of payments may be corrected”. Here the government restricts the free play of inflow and outflow of capital and the exchange rate of currencies. When tariffs and quotas do not help in correcting the adverse balance of trade and balance of payments the system of Foreign Exchange Control is restored to by Governments.

In other words Foreign Exchange Control means the monopoly of the government in the purchase and sale of foreign currencies in order to restore the balance of payments equilibrium.

According to Crowther:

“When the Government of a country intervenes directly or indirectly in international payments and undertakes the authority of purchase and sale of foreign currencies it is called Foreign Exchange Control”.

According to Haberler:

“Foreign Exchange Control in the state regulation excluding the free play of economic forces for the Foreign Exchange Market”.

Objectives of Foreign Exchange Control:

Important objectives of Exchange Control are as follows:

1.Correcting Balance of Payments:

The main purpose of exchange control is to restore the balance of payments equilibrium, by allowing the imports only when they are necessary in the interest of the country and thus limiting the demands for foreign exchange up to the available resources.

2. To Protect Domestic Industries:

The Government in order to protect the domestic trade and industries from foreign competitions, resort to exchange control. It induces the domestic industries to produce and export more with a view to restrict imports of goods.

3.To Maintain an Overvalued Rate of Exchange:

This is the principal object of exchange control. When the Government feels that the rate of exchange is not at a particular level, it intervenes in maintaining the rate of exchange at that level. For this purpose the Government maintains a fund, may be called Exchange Equalization Fund to peg the rate of exchange when the rate of particular currency goes up, the Government start selling that particular currency in the open market and thus the rate of that currency falls because of increased supply.

4. To Prevent Flight of Capital:
When the domestic capital starts flying out of the country, the Government may check its exports through exchange control.

5. Policy of Differentiation
The Government may adopt the policy of differentiation by exercising exchange control. If the Government may allow international trade with some countries by releasing the required foreign currency the Government may restrict the trade import and exports with some other countries by not releasing the foreign currency.

6. To Stabilize Exchange Rate:
The government may adopt exchange control to check fluctuations in the rate of exchange. Fluctuations in the rate of exchange are the normal feature in a free exchange market and cause disequilibrium in the economic life of a country. These fluctuations can be checked by officially fixing the exchange rate at a predetermined level.

7.To Conserve Foreign Exchange:
Exchange control may be used to conserve country’s foreign exchange reserves through exports. These reserves are restricted for- (a) paying off external debt, (b) importing essential goods for economic development, and (c) purchasing defence materials.

8. To Check Economic Fluctuations:
Cyclical fluctuations like depression and inflation, spread from one country to another through international trade. Exchange controls are used to check the spread of the destabilizing tendencies by controlling imports and exports.

9.To Check Undesirable Imports:
Exchange control is also needed to check the import of certain non-essential, harmful and socially undesirable goods in the country.

10.Other Objectives:
Apart from the above there may be certain other objectives of exchange control. These are:
(i) To earn revenue in the form of difference between selling and purchasing rates of foreign exchange.
(ii) To stabilize the exchange rates.
(iii) To make imports of preferable goods possible by making the necessary foreign exchange available.
(iv) To pay off foreign liabilities with the help of available foreign exchange resources.

Methods of Exchange Control:

The various methods of exchange control may broadly be classified into two types, direct and indirect. Direct methods of exchange control include those devices which are adopted by governments to have an effective control over the exchange rate, while indirect methods are designed to regulate international movements of goods.

Direct Methods of Exchange Control :

1. Intervention:

It refers to the government's intervention or interference in the free working of the exchange market with a view to overvalue or undervalue the country's currency in terms of foreign money.The government or its agency – the central bank – can intervene in the free market by resorting to buying and selling the home currency against foreign currency in the foreign exchange market to support or depress the exchange rate of its currency.

2.Exchange Restrictions:

Exchange restrictions refer to the policy or measures adopted by a government which restrict or compulsory reduce the flow of home currency in the foreign exchange market. Exchange restrictions may be of three types:

(i) The government may centralize all trading in foreign exchange with itself or a central authority, usually the central bank; (ii) the government may prevent the exchange of local currency against foreign currencies without its permission; (iii) the government may order all foreign exchange transactions to be made through its agency.

3.Pegging Operations:

Pegging means keeping a fixed exchange value of a currency. Pegging operations means buying and selling of the local currency by the central bank of a country in exchange for the foreign currency in the foreign exchange market, in order to maintain an exchange rate . Pegging may be □ □pegging up or □ □pegging down. Pegging up means holding fixed overvaluation, i.e., to maintain the exchange rate at a higher level. Pegging down means holding fixed undervaluation, i.e., to maintain the exchange rate at a lower level. In the case of pegging up, the central bank shall have to keep itself ready to buy unlimited amount of local currency in exchange for foreign currencies at a fixed rate. In the case of pegging down, the central bank or central agency shall have to keep itself ready to sell any amount to local currency by creating export surplus.

4.Blocked Accounts:

Blocked accounts refer to bank deposits, securities and other assets held by foreigners in a country. These accounts, cannot be converted into the creditor country’s currency. Under the blocked accounts scheme, all those who have to make payments to any foreign country will have to make them not to the foreign creditor directly but to the central bank of the country which will keep the amount in the name of the foreign creditor.

5.Exchange Clearing Agreements :

Under this device, two countries engaged in trade pay to their respective central banks the amounts payable to their respective foreign creditors. The exchange clearing is helpful to a country which has little or no foreign exchange reserves and which is more interested in selling than buying.

6.Multiple Exchange Rates :

Under this system, different exchange rates are set for different classes and categories of exports and imports. Generally a low rate, i.e., low prices of foreign money in terms of domestic currency, is confined to imports of necessary items having an inelastic demand, while a high penalty rate is fixed for the imports of luxury items. In short, the multiple exchange rates system implies official price discriminatory policy in foreign exchange transactions.

Indirect Methods of Exchange Control :

Apart from the direct methods, there are several indirect methods also regulating the rates of exchange. Important ones are briefly discussed below.

1.Changes in Interest Rates :

Changes in interest rate tend to influence indirectly the foreign exchange rate. A rise in the interest rate of a country attracts liquid capital and banking funds of foreigners which increase the demand for local currency and consequently the exchange rate move in its favor. A lowering of the rate of interest will have the opposite effect.

2.Tariffs Duties and Import Quotas :

The most important indirect method is the use of tariffs and import quotas and other such quantitative restrictions on the volume of foreign trade. Import duty reduces imports and with it rise the value of home currency relative to foreign currency. Similarly, export duty restricts exports; as a result, the value of home currency falls relative to foreign currencies. In short, when import duties and quotas are imposed, the rate of exchange tends to go up in favour of the controlling country.

3.Export Bounties :

Export bounties encourage the exports. It increases the external value of the currency of the subsidy-giving country. Import duty or export subsidy, each has its limitations. For instance, import duty cannot go so far as to completely restrict imports. There is also the fear of retaliation in regard to tariff policy. Similarly, the volume of subsidy depends upon the support of public fund. Likewise, manipulation of exchange rate through changes in interest rate may not be always effective.

Conclusion :

There are various forms in which the exchange control system may be devised. Each form has its own merits and demerits and each one serves a specific purpose. Therefore, the whole economic situation of foreign trade of a country must be carefully viewed while resorting to exchange control and more than one methods must be combined together.