Gresham's Law and Currency Exchange Rate

For Prelims: Fixed Exchange Rate, Floating and Managed Float Exchange Rate, Bretton Woods Conference, **2022 Sri Lankan Crisis**, **Inflation.**

For Mains: Advantages and Disadvantages of Fixed Exchange Rates, Alternatives to Fixed Exchange Rates.

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Why in News?

Gresham's law, attributed to **English financier Thomas Gresham**, was a significant factor in the **2022 economic crisis in Sri Lanka.** The crisis was characterized by the Central Bank of Sri Lanka's implementation of a **fixed exchange rate** between the **Sri Lankan Rupee and the U.S. Dollar.**

What is Gresham's Law?

- **Gresham's law** is a monetary principle that states that **"bad money drives out good". Bad money** is a currency with equal or less value than its face value. **Good money** has the potential for a greater value than its face value.
    - This means that if there are two types of **money in circulation**, one with a **higher intrinsic value and one with a lower intrinsic value**, people will tend to hoard the more valuable money and spend the less valuable money.
        - As a result, the **less valuable money will dominate the market,** while the more valuable money will disappear from circulation.
    - This law comes into play when the **government fixes the exchange rate between two currencies,** creating a disparity between the official rate and the market rate.
        - It applies not just to **paper currencies but also to commodity currencies** and other goods.
- **Instances of Gresham's Law in Action:**
    - Gresham's Law became noticeable during **Sri Lanka's economic crisis** when the country's Central Bank set a **fixed exchange rate between the Sri Lankan rupee and the U.S. dollar.**
        - Despite unofficial market rates suggesting that the U.S. dollar was worth much more, the **government insisted on a fixed rate of 200 Sri Lankan rupees for one U.S. dollar.**
        - This led to the **Sri Lankan rupee being considered more valuable than it actually was** and the U.S. dollar being undervalued according to market rates.
    - As a result, **fewer U.S. dollars were available in the official foreign exchange market**, and people started to avoid using them in official transactions.
- **Contrast to Gresham's Law:**
    - In contrast to **Gresham's Law, Thiers' Law** highlights a phenomenon where **"good money drives out bad."** In a free exchange rate environment, **people tend to favor higher-quality currencies and gradually discard those they perceive as inferior.**

        - The **rise of private cryptocurrencies (Good Money)** in recent years is often cited as an example of **how well-regarded, private money producers can displace government-issued currencies (Bad Money).**

What is a Fixed Exchange Rate?

- **About:**
    - A fixed exchange rate, also **called pegged exchange rate**, is a regime applied by a government or central bank that **ties the country's official currency exchange rate to another country's currency** or the price of gold.
        - The purpose of a fixed exchange rate system is to **keep a currency's value within a narrow band.**
- **History:**
    - The Bretton Woods Conference**, which took place in 1944,** established the international monetary system that was characterized by fixed exchange rates.
        - At the conference, participating countries agreed to peg their currencies to the U.S. dollar, which was convertible into gold at a fixed rate of **USD 35 per ounce.**
    - It aimed to **promote stability and prevent competitive devaluations of currencies**, which had contributed to **economic instability during the Great Depression and** World War II.
- **Downfall:**
    - The downfall of the fixed exchange rate system, established at the Bretton Woods Conference, was **due to persistent trade imbalances,** inflation**, speculative attacks, lack of exchange rate adjustability**, and **dwindling U.S. gold reserves.**
    - The **"Nixon Shocks" in 1971**, which included **suspending the U.S. dollar's convertibility into gold,** marked the system's collapse.
    - This **transitioned major currencies to floating exchange rates,** allowing flexibility in response to economic conditions.

What are Some Advantages and Disadvantages of Fixed Exchange Rates?

- **Advantages:**
    - **Price Stability**: Fixed exchange rates can provide **price stability.** This stability can be especially beneficial for countries with **high inflation rates or volatile currencies.**
    - **Reduced Transaction Costs**: In a fixed exchange rate system, businesses engaged in international trade may face **fewer currency-related transaction costs, such as currency conversion fees** and exchange rate risk management expenses.
    - **Investor Confidence:** Fixed exchange rates can **boost investor confidence.** Investors are more likely to commit capital to a country with a stable currency, reducing the cost of capital and potentially spurring economic growth.
- **Disadvantages:**
    - **Loss of Monetary Policy Autonomy:** One significant drawback is that countries adopting fixed exchange rates **give up control over their** monetary policy.
        - To maintain the peg, they may **need to adjust interest rates and money supply according to the anchor currency's policies,** which may not align with their domestic economic needs.
    - **Speculative Attacks:** Fixed exchange rate systems can be vulnerable to speculative attacks.
        - If investors believe a **country's currency is overvalued, they may engage in massive sell-offs**, forcing the central bank to deplete its foreign exchange reserves to maintain the peg.
    - **External Dependency:** Fixed exchange rate systems tie a country's **fortunes to the stability and policies of the anchor currency issuer.**
        - If the anchor currency faces problems, the pegged country may suffer without the ability to adjust its exchange rate.

What are Alternatives to Fixed Exchange Rates?

- **Floating Exchange Rate:** A **floating exchange rate**, also known as a flexible exchange rate, is a system where a **currency's value is determined by supply and demand in the foreign exchange market.**
    - In this system, exchange rates can fluctuate continuously and are not officially pegged or fixed to any other currency or commodity.
    - Floating exchange rates allow currencies to adjust freely to **economic conditions, trade imbalances, and market forces.**
        - **Example:** Canada and Australia.
- **Managed float: A** managed float exchange rate, also referred to as a **dirty float**, is a system where a **country's central bank or government occasionally intervenes in the foreign exchange market** to influence its currency's value.
    - While the exchange rate is allowed to float to some extent, **authorities may buy or sell their own currency to stabilize or manage its value** in response to certain economic goals or to prevent excessive volatility.
    - **Example**: India and China.

UPSC Civil Services Examination Previous Year Question (PYQ)

Prelims

Q1. Which one of the following is not the most likely measure the Government/RBI takes to stop the slide of the Indian rupee? (2019)

(a) Curbing imports of non-essential goods and promoting exports

(b) Encouraging Indian borrowers to issue rupee-denominated Masala Bonds

(c) Easing conditions relating to external commercial borrowing

(d) Following an expansionary monetary policy

Ans: (d)

Q2. Consider the following statements:

The effect of devaluation of a currency is that it necessarily

1. improves the competitiveness of the domestic exports in the foreign markets
2. increases the foreign value of domestic currency
3. improves the trade balance

Which of the above statements is/are correct?

(a) 1 only
(b) 1 and 2
(c) 3 only
(d) 2 and 3

Ans: (a)

Mains

Q. How would the recent phenomena of protectionism and currency manipulations in world trade affect macroeconomic stability of India? **(2018)**

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