Exchange Rate

Meaning of Foreign Exchange (FOREX)

FOREX refers to foreign currencies. The mechanism through which payments are effected between two countries having different currency systems is called FOREX system . It covers methods of payment, rules and regulations of payment and the institutions facilitating such payments.

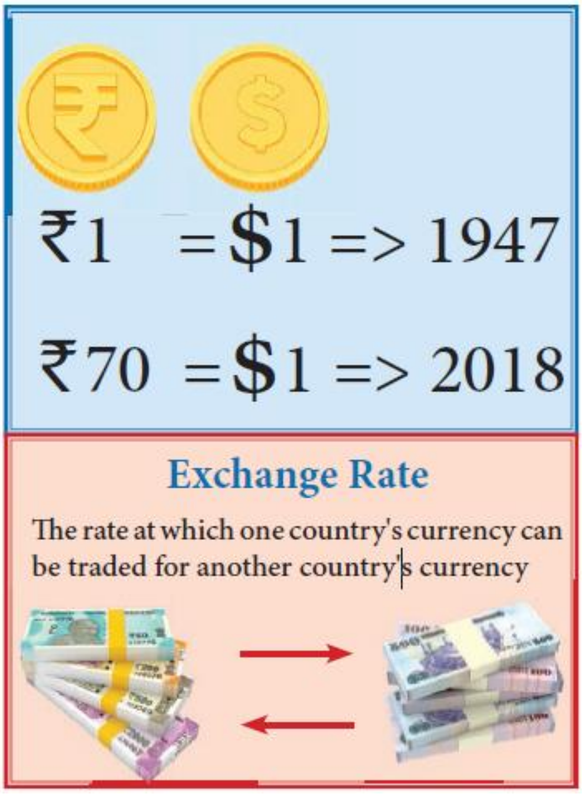
Defi nition of FOREX

"FOREX is the system or process of converting one national currency into another, and of transferring money from one country to another".

Rate of Exchange

The transactions in the exchange market are carried out at exchange rates. It is the external value of domestic currency. Thus, exchange rate may be defined as the price paid in the home currency (say ₹ 75) for a unit of foreign currency (say 1 US $). It can be quoted in two ways:

1. One unit of foreign money (1 USD) to so many units of the domestic currency (₹); or
2. A certain number of units of foreign currency (USD)to one unit of domestic money (₹ 1) For instance: 1 U.S Dollar = ₹ 70 , or ₹ 1 = U.S.1.42 cents



Definition of Equilibrium Exchange Rate

"The equilibrium exchange rate is that rate, which over a certain period of time, keeps the balance of payments in equilibrium". **- Ragner Nurkse**

Determination of Equilibrium Exchange Rate

The equilibrium rate of exchange is determined in the foreign exchange market in accordance with the general theory of value, i.e., by the interaction of the forces of demand and supply. Thus, the rate of exchange is determined at the point where demand for forex is equal to the supply of forex.

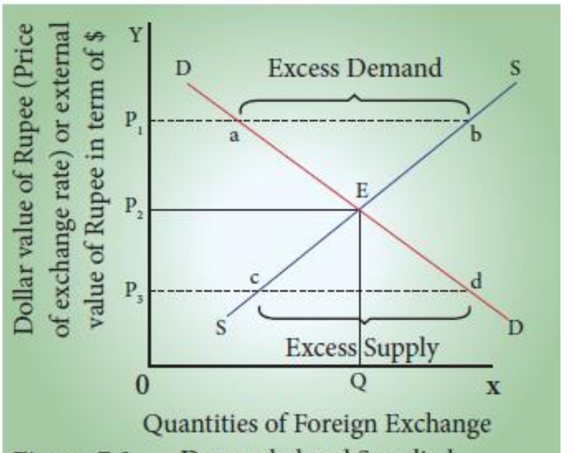


Figure 7.3

In the above diagram, Y axis represents exchange rate, that is, value of rupee in terms of dollars. X axis represents demand and supply of forex. E is the point of equilibrium where DD intersects SS. The exchange rate is P2.

Types of Exchange Rate Systems

Broadly, there are two major exchange rate systems, namely, (1) fixed (or pegged) exchange rate system and (2) flexible (or floating) exchange rate system. Managed Floating Exchange Rate system also prevails in some countries (like India).

1. Fixed Exchange Rates

Countries following the fixed exchange rate (also known as stable exchange rate and pegged exchange rate) system agree to keep their currencies at a fixed rate as determined by the Government. Under the gold standard, the value of currencies was fixed in terms of gold.

2. Flexible Exchange Rates

Under the flexible exchange rate (also known as floating exchange rate) system, exchange rates are freely determined in an open market by market forces of demand and supply.

Types of Exchange Rates

Exchange rates are also in the form of (a) Nominal exchange rate (b) Real exchange rate (c) Nominal Effective Exchange Rate (NEER) and (d) Real Effective Exchange Rate (REER)

If 1 US Dollar = ₹ 75,

Nominal exchange rate = 75/1 = 75.

This is the bilateral nominal exchange rate.

$$\text{Real Exchange rate} = \frac{eP_f}{P}$$

P = Price levels in India

P_f = Price levels in abroad (say US)

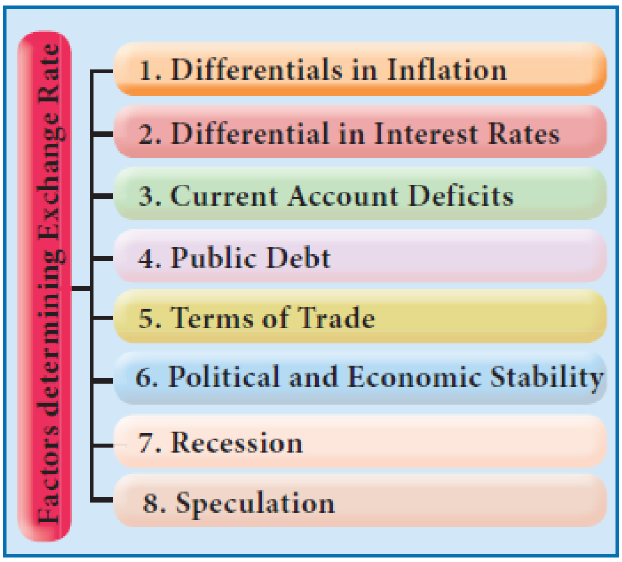
e = nominal exchange rate.

If a pen costs ₹ 50 in India and it costs 5 USD in the US,

$$\text{Real Exchange Rate} = \frac{75x5}{50} = 7.5$$

Determinants of Exchange Rates

Exchange rates are determined by numerous factors and they are related to the trading relationship between two countries.



1. Differentials in Inflation

Inflation and exchange rates are inversely related. A country with a consistently lower inflation rate exhibits a rising currency value, as its purchasing power increases relative to other currencies.

2. Differentials in Interest Rates

There is a high degree of correlation between interest rates, inflation and exchange rates. Central banks can influence over both inflation and exchange rates by manipulating interest rates. Higher interest rates attract foreign capital and cause the exchange rate to rise and vice versa.

3. Current Account Deficits

A deficit in the current account implies excess of payments over receipts. The country resorts to borrowing capital from foreign sources to make up the deficit. Excess demand for foreign currency lowers a country's exchange rate.

4. Public Debt

Large public debts are driving out foreign investors, because it leads to inflation. As a result, exchange rate will be lower.

5. Terms of Trade

A country's terms of trade also determines the exchange rate. If the price of a country's exports rises by a greater rate than that of its imports, its terms of trade will improve. Favorable terms of trade imply greater demand for the country's exports and thus BoP becomes favorable.

6. Political and Economic Stability

If a nation's political climate is stable and economic performance is good, its currency value will be appreciated by attracting more foreign capital.

7. Recession

Interest rates are low during the recession phase. This will decrease inflow of foreign capital. As a result, a currency will be depreciated against other currencies, thereby lowering the exchange rate.

8. Speculation

If a country's currency value is expected to rise, investors will demand more of that currency in order to make a profit in the near future. This results in appreciation of the exchange rate. Beside the above determinants, relative dominance in the global politics and the power to announce economic sanctions over other countries also determine exchange rates.