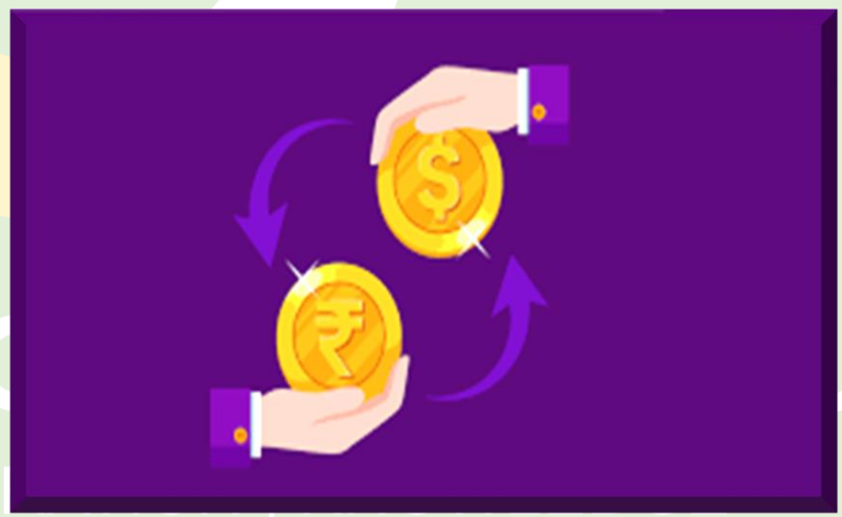
CHAPTER 6: OPEN MARKET – MACROECONOMICS

Foreign Exchange

Foreign exchange refers to the reserve of foreign currencies, e.g., currency of US and UK are the foreign exchanges for India.

Foreign exchange, or forex, is the conversion of one country's currency into another. In a free economy, a country's currency is valued according to the laws of supply and demand. In other words, a currency's value can be pegged to another country's currency, such as the U.S. dollar, or even to a basket of currencies.



FOREIGN EXCHANGE RATE

Foreign exchange rate refers to the rate at which one unit of domestic currency is exchanged with the number of units of currency of another country.

In simple words,

we can say that the price of one currency in terms of other currency is known as foreign exchange rate or exchange rate.

e.g. ₹ 80 are to be paid to buy one dollar,
then exchange rate is
$ 1 =₹60
(Written as /$ exchange rate).

Today,

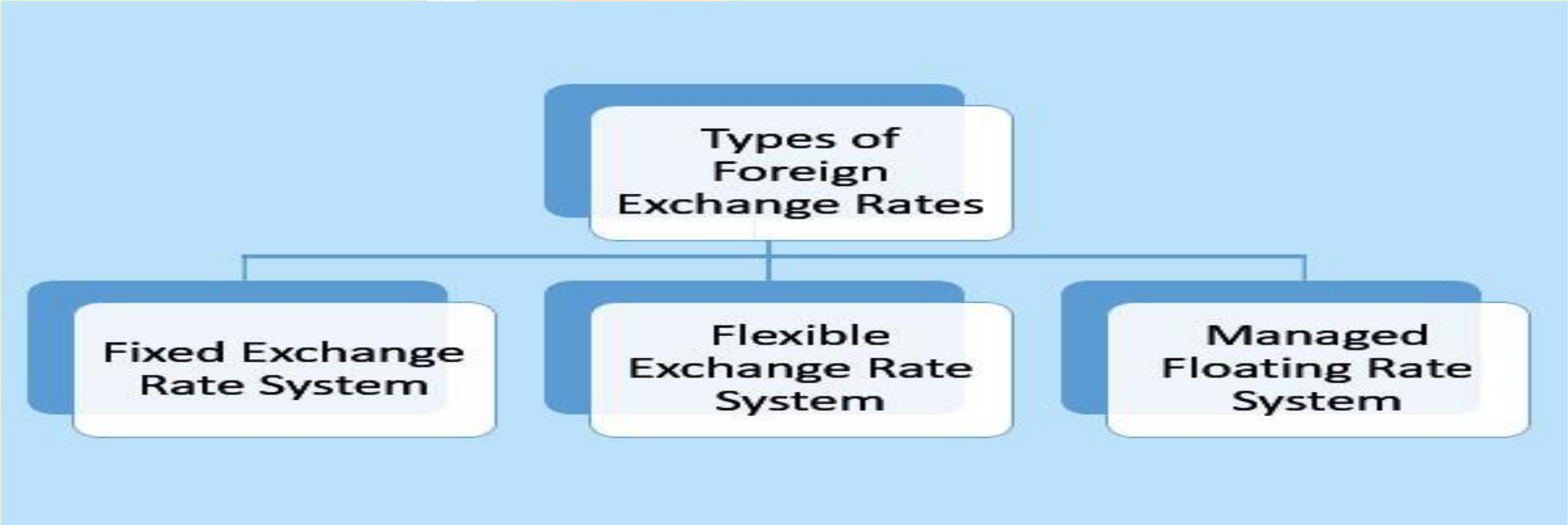
$1 = ₹82.06

1 Euro = 89.83 Indian Rupee
1 Pound = 101.86 Indian Rupee
1 Chinese Yuan =11.94 Indian Rupee

1 Kuwaiti Dinar=267.90 Indian Rupee
1 Japanese Yen = 0.61 Indian Rupee

Types of Exchange Rate

There are mainly three types of exchange rate, as discussed below:



1. Fixed Exchange Rate System

Under this system, exchange rate is determined by the Central Bank of a country and the changes can be made by the Central Bank only.

A fixed exchange rate system is undertaken by the government or central bank which ties the country's official currency exchange rate to another country's currency or the price of gold. A fixed exchange rate system **keeps a currency's value within a narrow band**.

Methods of Fixed Exchange Rate System

There are two methods to determine exchange rate under this system:

- **Gold standard system of exchange rate**
- **The Bretton Woods System of exchange rate**

Gold standard system of exchange rate

According to this system, gold was taken as the common unit of parity between currencies of different countries in circulation. Each country was to define the value of its currency in terms of gold. Accordingly, value of one currency in terms of the other currency was fixed, considering gold value of each currency.

The Gold Standard: A Fixed Exchange Rate System

- Between 1867 and 1933, most of the world's economies used the gold standard.
- Gold standard – a system of fixed exchange rates in which the value of currencies was fixed relative to the value of gold, and gold was used as the primary reserve asset.
- Each country agreed to pay a specified amount of gold on demand to anyone who wanted to exchange its currency for gold.

Advantages of Gold Standard implementation

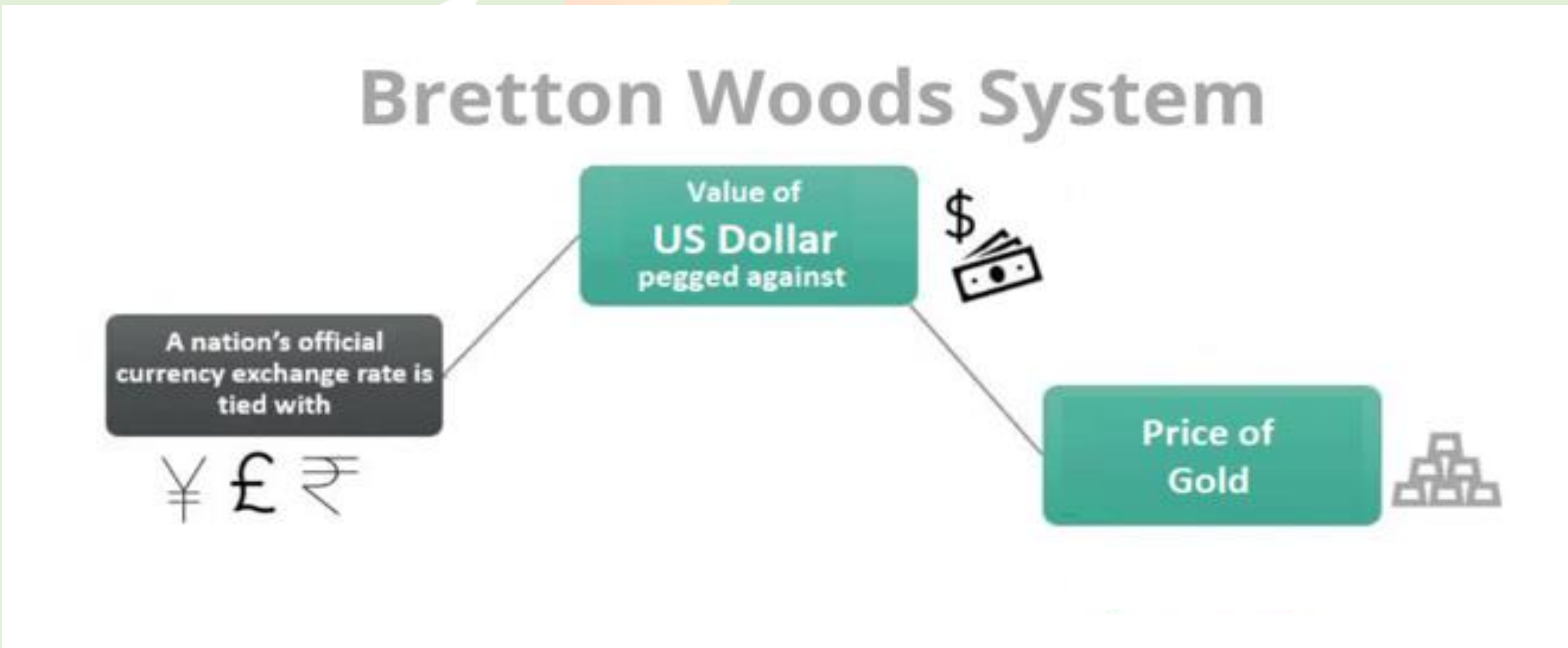
- Low transaction costs, since only accounting record need to be kept. (No LC, no exchange rate transaction costs, no exchange rate risk)
- Prevents multiple deposit creation in banks, money multiplying, and the resulting risks and speculation, and speculation in foreign exchange.
- Play the role of stable international unit of account
- Gold can be used for saving, as it is wealth in itself.
- Impacts on consumerism, political, religion, social order, technology and globalization would increase the economic stability of Muslim countries.

Problems with the Gold Standard

- Some believe gold resources would be depleted and prices of gold would be pushed up.
- Volatility of gold, due to its narrow market.
- Gold prices can also be manipulated, though not as easily as the U.S. dollar or other currencies. Speculation and manipulation will not be as easy as when local currency is valued against the U.S. dollar

The Bretton Woods System of exchange rate:

The Bretton Woods Conference held in 1944, re-established a system of fixed exchange rates. This was different from the international gold standard in the choice of the asset in which national currencies would be convertible. Under this system, countries were required to fix their currency against US dollar. International Monetary Fund was delegated with supervisory role under this system.



Bretton Woods system

- **Advantages:** significant expansion of international trade and investment as well as a notable macroeconomic performance

- **Disadvantages:**
- Exchange rate rigidity
- Pressure put on the United States
- Structure problems: US had to maintain increasing trade deficits. But the US was not able to devalue the dollar

=> The Bretton Woods system had been lasted until 1971. By 1973, the United States and other nations agreed to allow exchange rates to float.

Merits of Fixed Exchange Rate System

Following are the main merits of fixed exchange Rate:

1. It ensures stability in exchange rate. Due to certainty, it promotes foreign trade.
2. It promotes capital movements because it does not involve any uncertainties about exchange rate that may cause capital loss.
3. It prevents capital outflow.
4. It stops speculation in foreign exchange market. () It helps the government to check inflation. Demerits of Fixed Exchange Rate System

Demerits of fixed exchange rate system

1. It requires high reserves of gold. Huge gold reserves hinder movement of capital or foreign Exchange.
2. It discourages the objective of having free Markets.
3. It may result in undervaluation or overvaluation of currency.
4. It may not be the market equilibrium.
5. An economy following this system, may find it depression Difficult to combat either Recession.

Currency Devaluation and Revaluation

Under a fixed exchange rate system, devaluation and revaluation are official changes in the value of a country's currency relative to other currencies.

Devaluation is when the price of the currency is officially decreased in a fixed exchange rate system.

$1 = ₹83 → $1 = ₹85

Revaluation is when the price of the currency is increased within a fixed exchange rate system.

$1 = ₹83 → $1 = ₹81

FLEXIBLE EXCHANGE RATE SYSTEM

Under this system, the exchange rate for the currency is fixed by the forces of demand and supply of different currencies in the foreign exchange market. This system is also called the Floating Rate of Exchange or **Free Exchange Rate**.

- Under the Flexible Exchange Rate system, there is no intervention by the government.
- It is called flexible because the rate changes with the change in the market forces.
- The exchange rate is determined through interactions of banks, firms, and other institutions that want to buy and sell foreign exchange in the foreign exchange market.

Merits of Flexible Exchange Rate System

1. With the flexible exchange rate system, there is no need for the government to hold any reserve.
2. It eliminates the problem of overvaluation or undervaluation of the currency.
3. It encourages venture capital in the form of foreign exchange.
4. It also enhances efficiency in the allocation of resources.

Demerits of the Flexible Exchange Rate System

1. It encourages speculation in the economy.
2. There is no stability in the economy as the exchange rate keeps on fluctuating as per demand and supply.
3. Under this, coordination of macro policies becomes inconvenient.
4. There is uncertainty in the economy that discourages international trade.

MANAGED FLOATING

It is **a mixture of a flexible exchange rate system (the float part) and a fixed exchange rate system (the managed part),** wherein exchange rate is determined in the foreign exchange market freely by the market forces of demand and supply. However, excessive fluctuation is checked by the Central Bank. Managed floating is also known as dirty floating, if a country manipulates the exchange rate by not following rules and regulations.

Objectives of a Managed Floating System

Developing countries with high GDP growth rates usually prefer a managed floating exchange. Since there are bound to be geopolitical events beyond their control, such countries including India have placed a great deal of emphasis on this hybrid system. Here are the four main objectives of a dirty float.

Advantages of a Managed Floating Regime

- A much stronger and more resilient monetary policy. Since the Central Bank and the Government work in tandem, there are little chances of differences in opinion at the very top.
- The domestic economy is hardly impacted by the actions taken under a managed floating regime. It must be remembered that such a regime allows a high amount of autonomy to market forces to correct themselves, and the economy by extension. If this does not happen, the central agencies step in to make amends.

What is Depreciation of a Currency?

Due to the ongoing operation of various market forces, the external value of a domestic currency may decrease causing what is known as depreciation. It means that the value of a given currency is less than the value of another foreign currency.

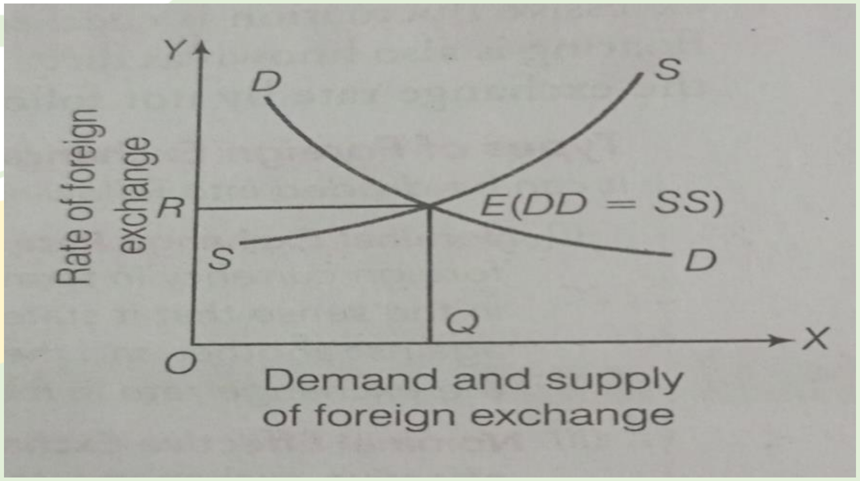
What is Appreciation of a Currency?

When the external value of a domestic currency increases because of the different market forces of demand and supply, it causes what is known as an appreciation. It means that the value of a given currency is more than the value of another foreign currency.

DETERMINATION OF FOREIGN EXCHANGE RATE

Foreign exchange rate is determined by the demand and supply of foreign exchange. The rate of foreign exchange is said to be in equilibrium, when the demand for some currency in terms of another currency equals its supply In the given figure, the line SS shows the supply of foreign currency which is positively related to the rate of exchange.

The line DD shows the demand for foreign currency which is negatively related to the rate of exchange. The point E, which DD equals to SS, represents the equilibrium rate of exchange.



Sources of Demand for Foreign Exchange

Foreign exchange is demanded for the following purposes (1) Purchase of foreign goods by domestic residents, i.e.

Imports.

(i) Payments of international loans
(ii) Gifts and grants to the rest of the world.
(iii) Investments in the rest of the world.
(iv) Tourism to abroad.

Sources of Supply of Foreign Exchange

Supply of foreign exchange depends on the following factors:

1. Purchases of domestic goods by the foreigners, i.e. exports.
2. Foreign Direct Investment as well as portfolio investment from rest of the world.
3. Speculative purchases of foreign exchange.
4. Tourism and remittances from abroad.
5. Transfer of foreign exchange by the residents of the country abroad

FOREIGN EXCHANGE MARKET

Foreign exchange market is the market in which national Currencies are traded for one another. The major participants in this market are commercial banks, MNC's shares brokers, other authorised dealers and monetary authorities.

Types of Foreign Exchange Market

- **Spot market**

The market which handles only spot or . current transactions of foreign exchange are termed as spot market or current market.

- **Forward market**

The market of foreign exchange which deals with the purchase and sale of foreign exchange which are contracted today, but are implemented in future is called forward market.

Functions of Foreign Exchange Market

<u>Transfer function,</u> It facilitates transfer of purchasing power across different countries of the world.

<u>Credit function,</u> It facilitates credit for international trade.

<u>Hedging function,</u> It facilitates protection against risks of

S.NO.	BASIS	FIXED EXCHANGE RATE SYSTEM	FLEXIBLE EXCHANGE RATE SYSTEM
1	Determination of exchange rate	In this system, exchange rate is fixed by measuring the value in terms of gold or any other currency by the government.	In this system, exchange rate is determined by the market forces of demand and supply in the foreign exchange market.
2	Government control	There is complete government intervention in fixing the exchange rate.	There is no government intervention in fixing the exchange rate.
3	Stability in exchange rate	There is stability in the foreign exchange rate. The exchange rate is stable or there is only a small variation in the exchange rate.	There is no stability in foreign exchange rate. The exchange rate keeps on changing.

Balance of Payments

The balance of payment is the statement that files all the transactions between the entities, government anatomies, or individuals of one country to another for a given period of time. All the transaction details are mentioned in the statement, giving the authority a clear vision of the flow of funds.

Key Points of BOP:

- The balance of payments (BOP) is the record of all international financial transactions made by the residents of a country.
- There are three main categories of the BOP: the current account, the capital account, and the financial account.
- The current account is used to mark the inflow and outflow of goods and services into a country.
- The capital account is where all international capital transfers are recorded.
- In the financial account, international monetary flows related to investment in business, real estate, bonds, and stocks are documented.
- The current account should be balanced versus the combined capital and financial accounts, leaving the BOP at zero, but this rarely occurs.

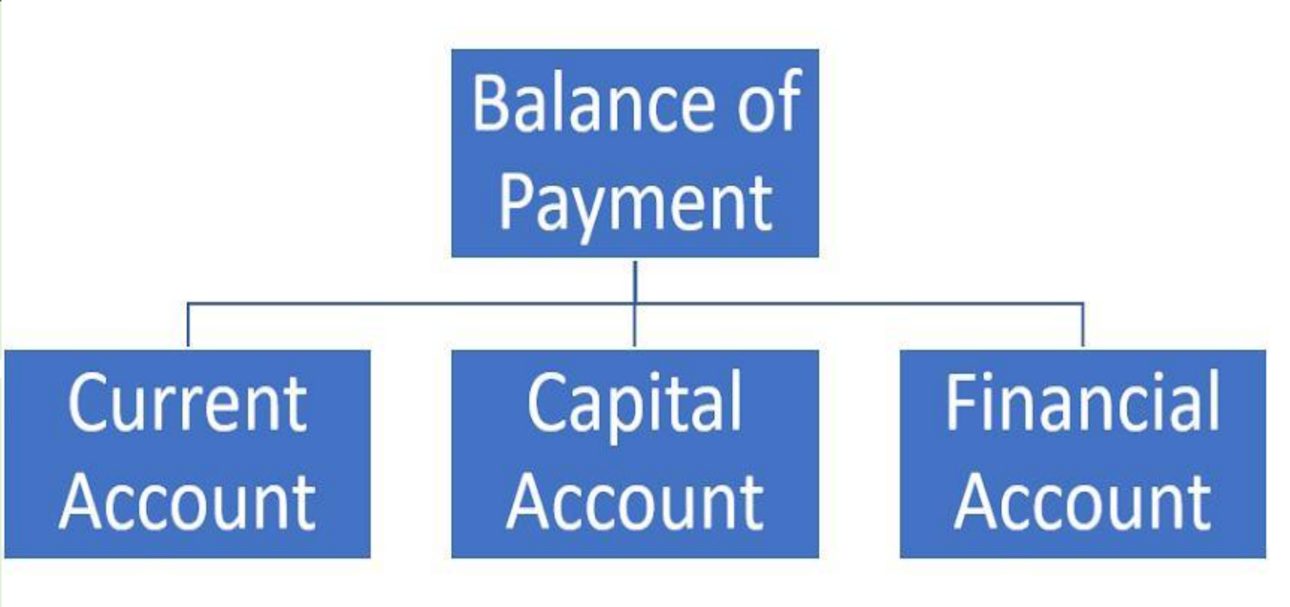
Economic Transactions in BoP

- **Visible:** These include the export and import of all types of tangible goods. These are called 'visible', as they can be touched, seen, felt, and measured. The movement of visible items is open and is verifiable through customs officials.
- **Invisible:** These include the export and import of services, like software services, insurance, shipping, banking, etc. These are called 'invisible', as they cannot be touched, seen, felt, or measured.
- **. Capital Transfers:** These include capital receipts and capital payments. Receipts that increase financial liabilities or decrease financial assets are known as capital receipts. For example, the sale of assets or borrowing. In both cases, there is an inflow of cash.
- **Unilateral Transfers**: These are one-sided transactions that include the transfer of goods and services without any claims for repayment. For example, a child studying abroad sends gifts to her parents. It also considers grants and donations that one government sends to other foreign governments

Importance of Balance of Payment

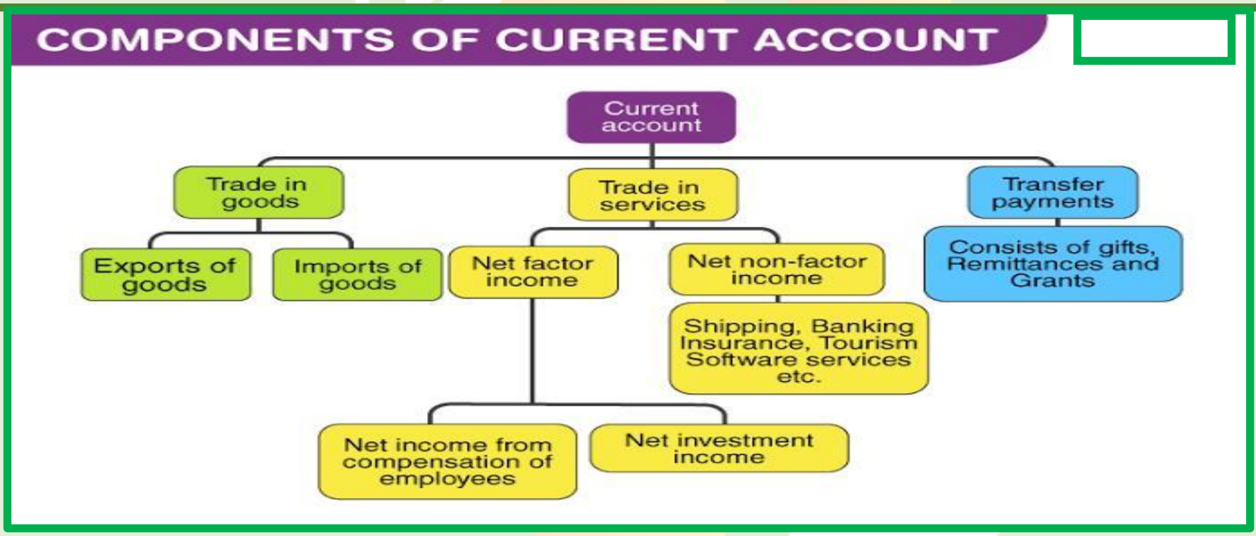
- *It examines the transaction of all the exports and imports of goods and services for a given period.*
- *It helps the government to analyse the potential of a particular industry export growth and formulate policy to support that growth.*
- *It gives the government a broad perspective on a different range of import and export tariffs. The government then takes measures to increase and decrease the tax to discourage import and encourage export, respectively, and be self-sufficient.*

Components of Balance of Payment



Current account:

This account scans all the incoming and outgoing of goods and services between countries which also included in this category are from tourism, engineering, stocks, business services, transportation, and royalties from licenses and copyrights. All these combines together to make a BOP of a country.



Components of Current Account

1. Export and Import of Goods (Visible Trade or Merchandise Transactions)

Transactions in foreign trade mostly include the export and import of goods or visible items. Payment for the import of visible items or goods is recorded on the debit side and receipt from exports of visible items is recorded on the credit side of the Balance of

Payment Account. The balance of the visible export and imports of goods is called Balance of Trade or Trade Balance.

2. Export and Import of Services (Invisible Trade)

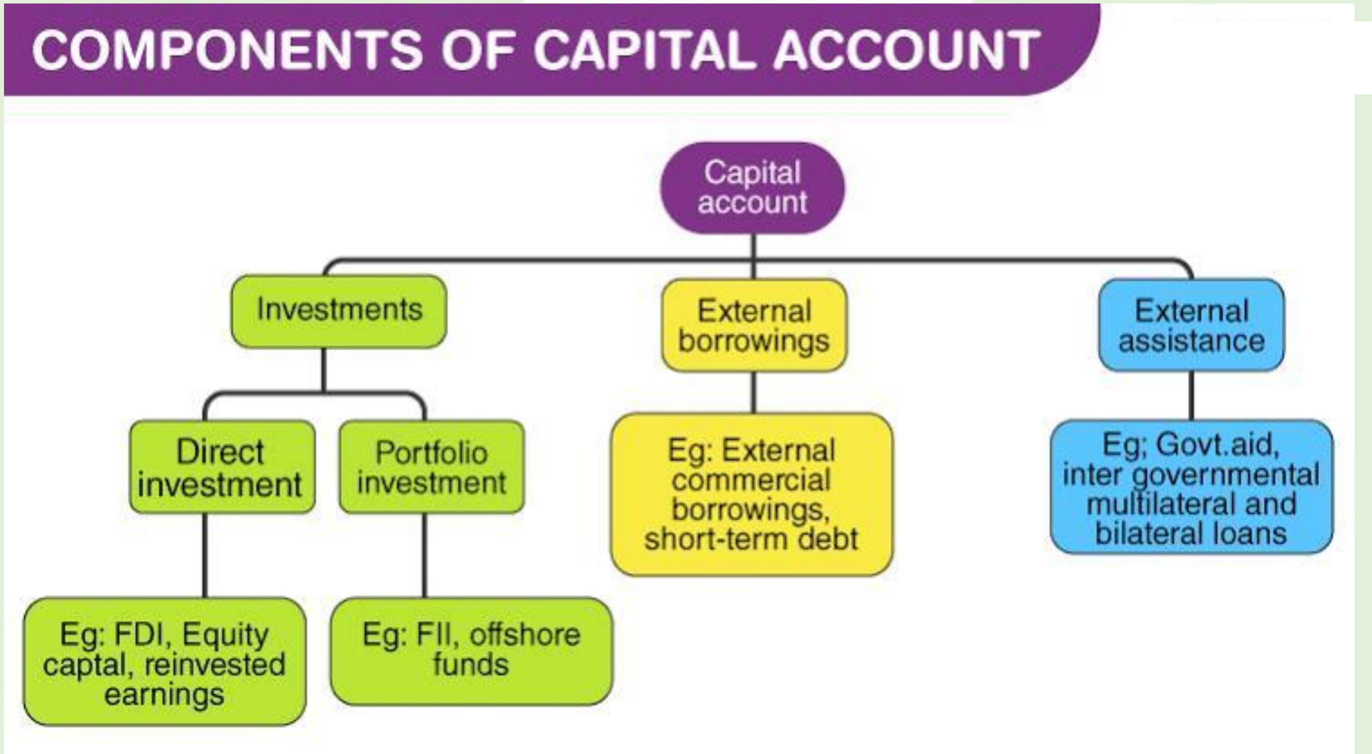
It is also known as Invisible Trade because the services being intangible cannot be spotted moving across the border. For example, insurance and banking. The balance of the invisible items (exports – imports) is known as the Balance of Invisible Trade.

3. Unilateral or Unrequited Transfers to and from abroad (One-sided Transactions)

These are one-sided transactions and are commonly named transfers for free. These are payments and receipts that occur without receiving any in-kind services example: gifts, grants, and donations.

Capital account:

Capital transactions like purchase and sale of assets (non-financial) like lands and properties are monitored under this account. This account also records the flow of taxes, acquisition, and sale of fixed assets by immigrants moving into the different country.



Components of Capital Account

1. Borrowings and Lendings to and from abroad

The capital account consists of all the transactions related to borrowings from abroad by the government, private sector, etc.

The receipts and repayments of such loans are recorded on the credit side of the BoP.

Similarly, all the transactions related to 'lending to abroad' by the government and private sector are included in the capital account. These transactions are recorded on the debit side of the BoP.

2. Investments to and from abroad

all the investments by the rest of the world in shares of Indian companies, real estate, etc.

These transactions from the rest of the world are recorded on the credit side of BoP, as these transactions bring foreign exchange to the country.

There are two types of investments to and from abroad:

Foreign Direct Investment: FDI consists of the purchase of an asset, which gives direct control to the buyer over the asset. For example, purchase of land, building, etc.

Portfolio Investment: It consists of the purchase of an asset that does not give any direct control over the asset to the purchaser. For example, purchase of shares. Portfolio Investment also consists of FII (Foreign Institutional Investment).

3. Change in Foreign Exchange Reserves

The financial assets of the government held in the central bank are known as the Foreign Exchange Reserves. If there is a change in the reserves, it serves as the financing item in India's BoP. Hence, any withdrawal from the reserves is recorded on the credit side of BoP, and any addition to these reserves is recorded on the debit side of BoP. Also, any change in the reserve is recorded in the BoP account and not in 'Reserves'.

Finance account:

The funds that flow to and from the other countries through investments like real estate, foreign direct investments, business enterprises, etc., is recorded in this account. This account calculates the foreign proprietor of domestic assets and domestic proprietor of foreign assets, and analyses if it is acquiring or selling more assets like stocks, gold, equity, etc.