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Foreign Exchange Rate

FOREIGN EXCHANGE MARKET

The market in which foreign currencies are bought and sold is called the foreign exchange market.

The major participants in the foreign exchange market are: Commercial banks, foreign exchange brokers, other authorised dealers and the monetary authorities. A foreign exchange market performs following important functions:

1. The principal function of a foreign exchange market is to transfer purchasing power from among countries (transfer function).

2. The second function is to provide credit for international trade (Credit function).

3. The third function is to make provision for hedging facilities i.e. to facilitate buying and selling spot or forward foreign exchange.

Foreign bills of exchange, telegraphic transfer, bank draft, letter of credit etc. are the important foreign exchange instruments used in the foreign exchange market to carry out its functions.

MEANING OF FOREIGN EXCHANGE

Foreign exchange refers to all currencies other than the domestic currency.

The rate at which one currency is exchanged for the other is known as the rate of exchange or foreign exchange rate.

TYPES OF FOREIGN EXCHANGE RATE SYSTEM

Two important foreign exchange system are:

1. FIXED (OR PEGGED) EXCHANGE RATE SYSTEM

In fixed or pegged exchange state system central bank or the government fixes and maintains the exchange rate.

Merits or Advantage of fixed Exchange Rate system

1. Stability in exchange rate encourages international trade.

2. International investment is promoted through a system of stable exchange rate.

3. Fixed exchange rate system removes the Possibilities of speculation.

4. Stable exchange rate forces the government to keep inflation in check.

5. Stable exchange rate prevents Capital outflow from the country.

Demerits or Problems of Fixed Exchange Rate system

1. Central bank, has to intervene to finance balance of payments deficit and to maintain the fixed exchange rate.

2. When speculator come to know that the fixed exchange rate cannot

be held for long their demand for foreign exchange would rise. This causes a further deficit in the balance of payments. Due to depletion of foreign exchange reserves, the country is forced to devalue its currency to overcome the deficit.

2. FLEXIBLE (OR FLOATING) EXCHANGE RATE SYSTEM

The system of exchange rate in which the value of a currency allowed to adjust freely or to float as determined by demand for or supply of foreign exchange is called a flexible (or floating) exchange rate system.

Merits or Advantages of Flexible exchange

1. There is no need for central banks to have foreign exchange reserves under the system of flexible exchange rates system.

2. Flexible exchange rates remove hurdles in the way of international trade and Capital movement.

3. Flexible exchange rates provide opportunity for the optimum utilisation of resources and thus raise the level of efficiency in the economy.

4. It eliminates the problem of over valuation or under valuation of Currencies. Deficit or surplus in balance of payment is automatically corrected under this system.

Demerits of Flexible Exchange Rate system

1. Too frequent fluctuations in exchange rate bring instability that hampers foreign trade and capital among the countries.

2. Under flexible exchange rates, the price of foreign exchange is quite uncertain. As a result, people are unable to take proper decision regarding export and imports of goods.

3. Whenever due to deficit in balance of payment, the currency depreciates, the prices of import go up. The higher prices of imported materials raise the prices of industrial product and thus generate inflationary pressure in the economy.

3. MANAGED FLOATING SYSTEM

Under the system of managed floating, floating of exchange rate is not completely free, and it is managed by monetary authority of the country in the Best interest of the country.

DETERMINATION OF EXCHANGE RATE IN A FREE MARKET

The Exchange rate is the price of a currency in terms of another Currency. In other words, exchange rate is the rate at which currency of a country is brought and sold against the currency of another Country in the foreign exchange market. Just as the price of a commodity is determined by the forces of demand and supply in the product market, similarly, the exchange rate is also determined by the Interaction of demand and supply in the foreign exchange market.

1. Demand for foreign Exchange

Desire to have foreign exchange creates demand for foreign exchange. Following are the main reason for demand for foreign exchange:

(i) Import of goods and services from foreign countries.

(ii) Purchase of assets in foreign countries.

(iii) Sending gifts abroad.

(iv) Speculation on the value of foreign currencies also creates demand for foreign exchange.

The demand for foreign exchange rises or falls with the fall or rise “in foreign exchange rate. Hence demand curve is downward sloping curve from left to the right.

2. Supply of Foreign Exchange

(i) Export of goods and services to foreign Countries.

(ii) Purchase of assets by foreigners.

(iii) Receiving gifts from the rest of the world.

(iv) Inward movement of foreign Currencies due to Currency dealers and speculators.

(v) Other receipts involved in international transactions.

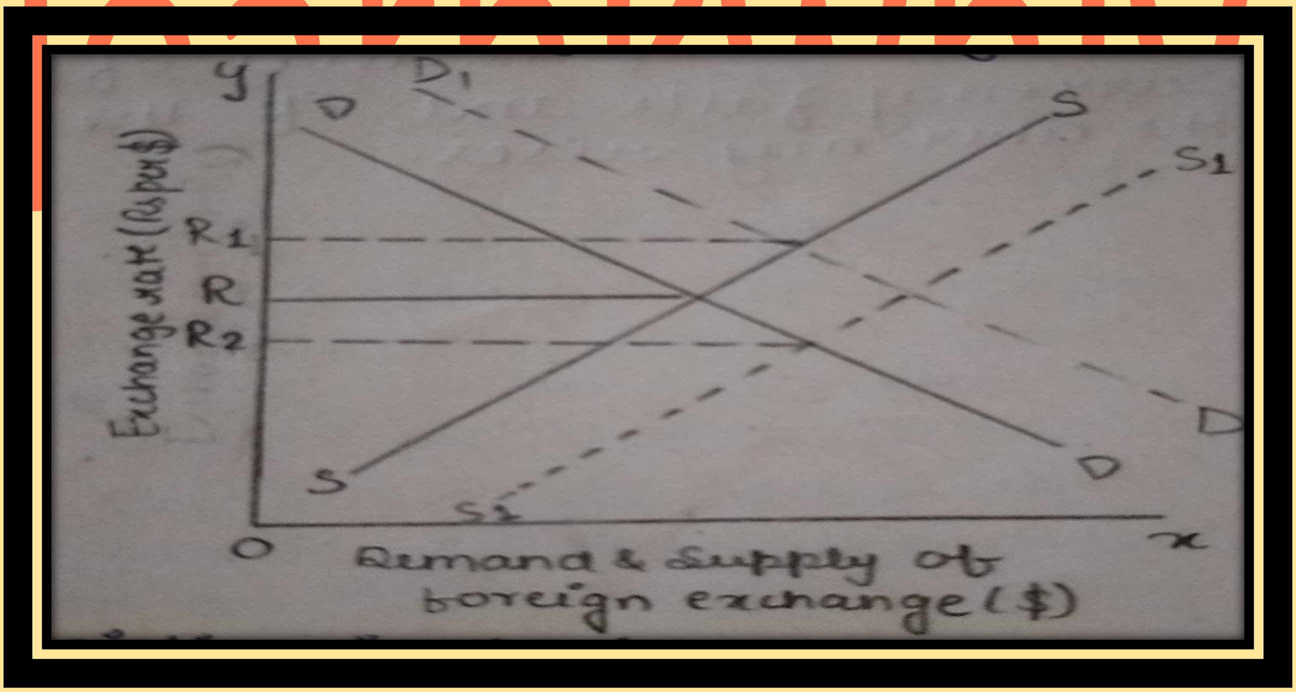
The supply for foreign exchange rise or fall with the rise or fall in foreign exchange foreign exchange rate. Hence there is an upward sloping curve.

DETERMINATION OF EQUILIBRIUM EXCHANGE

Equilibrium Exchange Rate is determined by the equality between the demand for and supply of foreign exchange.

The exchange rate is determined where the demand for dollars becomes equal to its supply or where the foreign exchange demand curve and supply intersect each other. In diagram, DD demand curve intersect SS curve at point E. Thus, the rate at which demand for foreign exchange become equal to the supply of foreign exchange, is termed as equilibrium rate of exchange. If the rate of exchange is OR_1 there is excess supply of dollars (D_1S_1) as a result of which exchange falls from OR_1 to OR. On the other hand, if the rate of exchange is below the equilibrium exchange, OR_2, the demand for dollars exceeds the supply of dollars by S_2D_2.

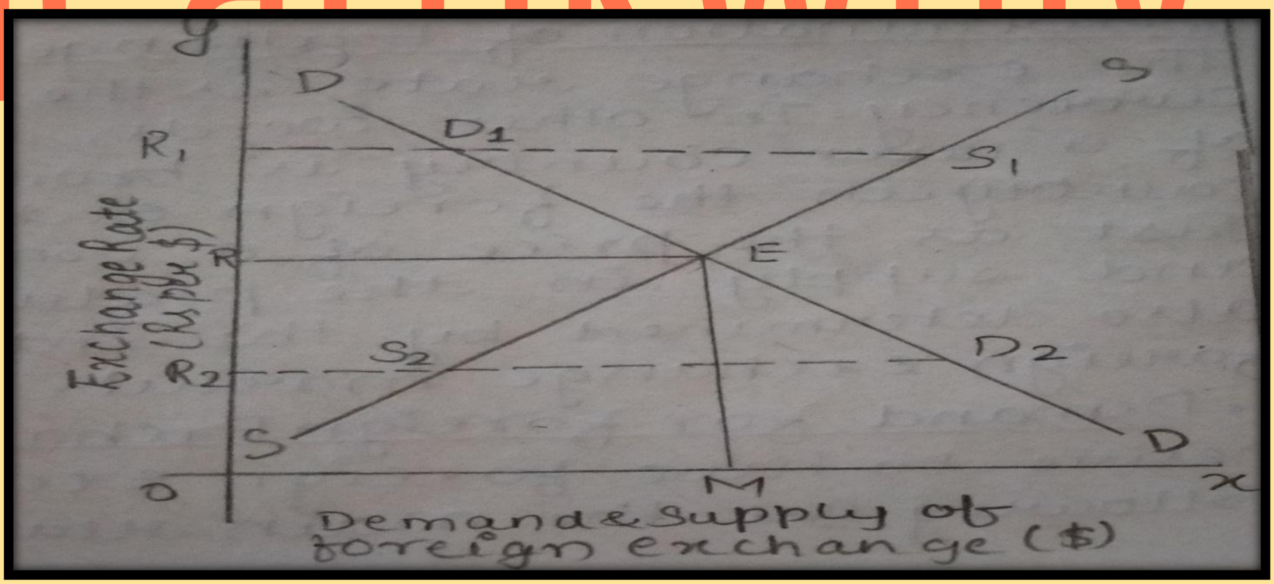
As a result, the exchange rate will rise from OR_2 to OR. Thus, the equilibrium rate of exchange is always determined by the equality between demand for and supply of foreign exchange.



EFFECT OF CHANGE IN DEMAND FOR AND SUPPLY OF FOREIGN EXCHANGE

when there is increase in the demand for foreign exchange causing an upward and shift in the demand curve, it leads to a rise in exchange foreign exchange and vice versa. Similarly, an increase in supply of foreign exchange, causing a rightward (or downward) shift in supply curve, leads to fall in exchange rate and vice versa. However the extent of change in demand or supply curve depends on the degree of their respective elasticity.

If there is increase in the exchange rate of dollars in term of rupees, it means now more rupees are required because rupee is depreciating and Value of dollar is appreciating. On the other hand, if there is decrease in the exchange rate of dollars in term of rupees, it means now less rupees are exchange required to buy one dollars. In this case the value of Indian rupee is appreciating and the value of dollar is depreciating.



FACTOR AFFECTING EXCHANGE RATE

1.Speculation - Speculative activities influence the exchange rate of

a country. If the future price of a foreign currency is expected to be greater than the present price, speculator will buy the foreign currency. It increases the demand for foreign currency in the current period and its exchange rate goes up.

2. Interest Rates and Exchange Rate: - Difference of Interest rates between two countries also affect the exchange rate in the short run.

3. Changes in income and Exchange Rate: Change in income also affect exchange rate, when there is increase in income, consumer spending's on the imported goods also increases. Consequently, domestic currency depreciates.

4. Determination of Exchange Rate in the long run: Changes in purchasing power of money: According to Purchasing power parity (PPP) Theory, in the long run, the rate of exchange between two currencies is determined by their respective purchasing power. Whenever the purchasing power of money changes, the rate of exchange also changes.