

Foreign Exchange Rate

Foreign exchange rate :- It refers to the rate at which one unit of currency of a country can be exchanged for the no. Of units of currency of another country.

1\$ = Rs. 50 Or Re 1 – 1/50\$ = 2 Cents.

System / Type of exchange Rate.

1. Fixed exchange rate system :- It is the system of exchange rate which is fixed by the gov. It has two important variants :
 - a) Gold standard system of exchange rate :- each country was to define value of its currency in terms of gold. Value of one currency in terms of the other currency was fixed considering gold value of each currency. For eg: -

1UK \$ (pound)	=	4gm of gold.
1US \$ (dollar)	=	2 gm of gold.
Then 1UK £	=	2 US \$

Exchange rate/ ration btw. UK£ and US \$ = 1:2. 2 US \$ would exchange for 1 UK £.
It is also known as mint par value of exchange or mint parity.

Bretton woods System of exchange Rate:-

OR

Adjustable Peg system exchange rate:-

According to this system :

- Different currencies were pegged (or related to) to one currency, that is US dollar.
 - US dollar was assigned gold value at a fixed rate
 - Value of one currency in terms of US dollar ultimately implied value of that currency in terms of gold.
 - Gold continued to be the ultimate unit of parity between any two currencies.
 - Adjustment in the parity value of a currency was possible but only if allowed by IMF (International monetary fund).
2. Flexible exchange rate system:- Flexible rate of exchange is that rate which is determined by the demand for and supply of different currencies in the foreign exchange market. It is determined by the market forces.
The exchange rate at which demand for foreign currency is equal to its supply is called Par rate of exchange and it constitute the normal rate or equilibrium rate. It is a flexible rate because it tends to change in accordance with changes in the supply of and demand for different currencies in the foreign exchange market.

Determination of Flexible rate of Exchange :

It is determined by the forces of supply and demand in the foreign exchange market. The rate of exchange of a country's currency is determined by the demand for and supply of its currency.

Other things remaining constant if the demand for foreign exchange rises, its value (or market price) will also rise and if demand for foreign exchange falls its value will also fall. On the other hand if the supply of foreign exchange rises its value will fall and if supply for foreign exchange falls, its value will rise.

Demand for foreign exchange :- it is demanded for the purpose of :

- Payments of international loans
- Gifts and grants to rest of the world.
- Direct purchases abroad as well as imports from rest of the world.
- Speculative trading in foreign exchange by our residents.

Supply of foreign exchange : - Depends on the following factors.

- Exports of the country to rest of the world
- Direct foreign investment
- Direct purchases of goods and services by the non-residents in the domestic market.
- Speculative purchases by the non-residents in the domestic market
- Remittances by the non-residents bring in foreign countries.

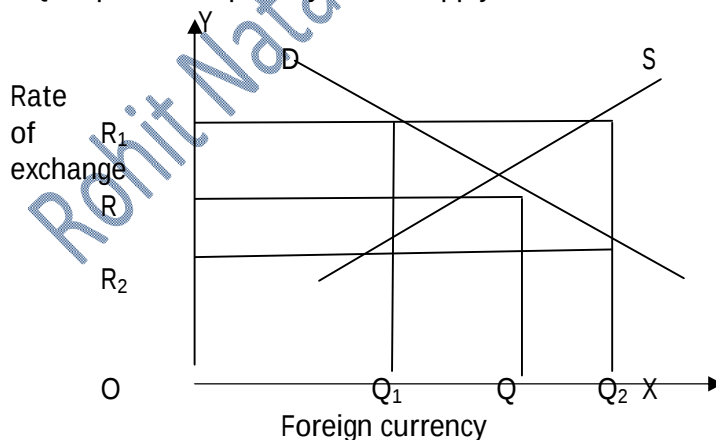
Equilibrium rate of exchange :- occurs where supply of an demand for exchange are equal to each other.

SS. Supply of foreign currency it is positively related to the rate of exchange

DD. demand for foreign currency it is negatively related to the rate of exchange

E: point of equilibrium rate of exchange where supply and demand curves intersect each other.

OQ : Equilibrium quantity where supply and demand for foreign exchange are equal.



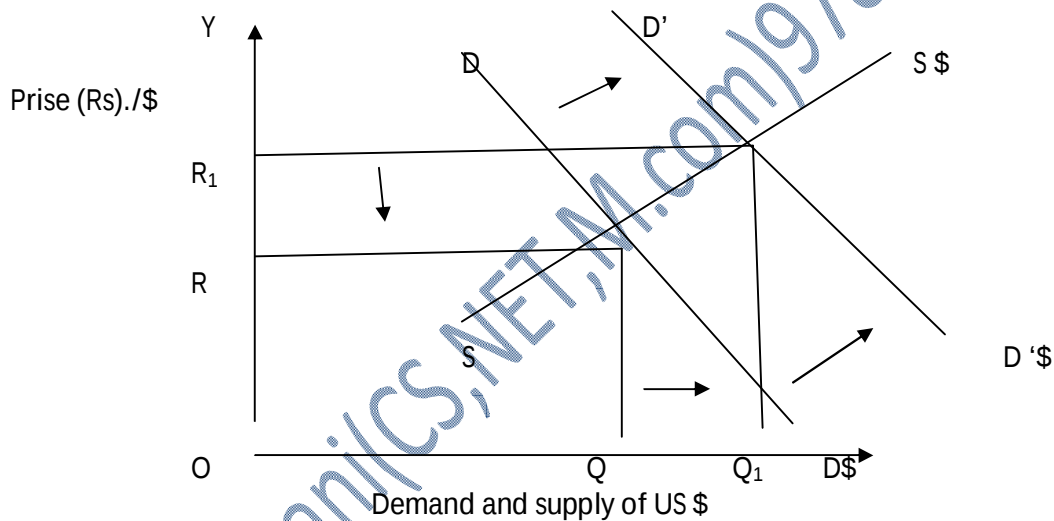
Supply and demand are measured on the X-axis, and exchange rate on the Y-axis. DD is the demand curve and SS is the supply curve of foreign exchange. Both these curves intersect at point E. It is an equilibrium point and or is the equilibrium rate of exchange.

If the rate of exchange rises to OR_1 , then supply of foreign currency (OQ_1) will exceed its demand (OQ_2) by an amount equivalent to $Q_2 - Q_1$ Supply being more than demand rate of exchange will come down to OR .

On the contrary, if the rate of exchange falls to OR_2 then demand for foreign currency (OQ_1) will be more than its supply (OQ_2) by $Q_2 - Q_1$... demand being more than supply rate of exchange will again rise to OR . Rate of exchange will therefore be determined at a point where demand for and supply of foreign currency are equal.

Impact of change in demand and supply

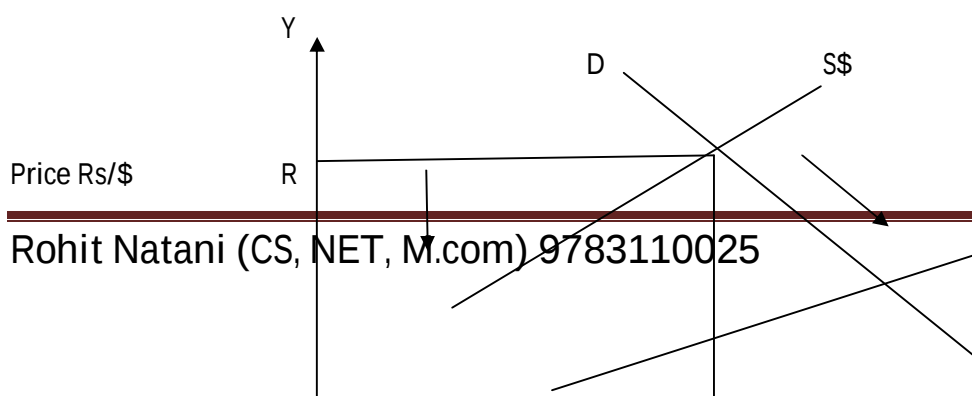
- 1) An increase in the demand for US dollars in India will shift the demand curve to right as a result exchange rate rises from OR to OR_1 i.e. more rupees notes will be required to buy one US \$. This means that Indian rupee is depreciating. Currency depreciation takes place when there is an increase in the domestic currency price of the foreign currency. The domestic currency is thus relatively less valuable.

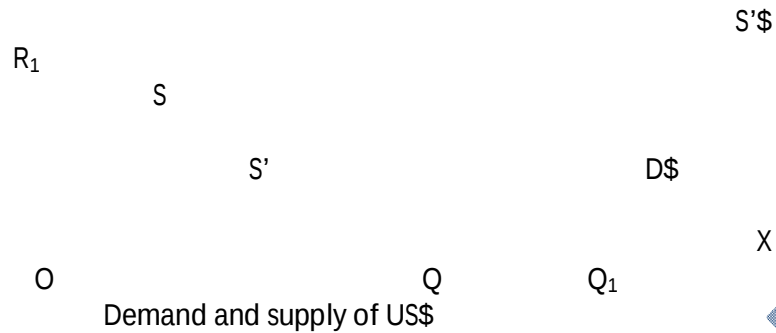


DD: The initial demand curve for US \$

D'D' : A forward shift in demand curve for US \$ price of a US\$ rises from OR to OR_1 , it is a situation of a rise in exchange rate ; dollar is appreciating while rupee is depreciating.

- 2) An increase in supply of US dollars will cause supply curve to shift rightwards and exchange rate to fall. In this case rupee price of US dollar decreases from OR to OR_2 , and Indian rupee is appreciating. Currency appreciation takes place when there is a decrease in the domestic currency price of the foreign currency. In this case, the domestic currency is more valuable.





SS: Initial supply curve of US \$

S'S' : A forward shift in supply curve for US \$

Price of US \$ decreases from OR to OR₁. It is a situation of a fall in exchange rate. Dollar is depreciating while rupee is appreciating.

Appreciation of Domestic currency :- It occurs when the value of our currency increases in relation to the value of other currencies.

For Eg: If US \$ exchange for Rs. 38 instead of Rs. 40 then the domestic currency (Indian Rupee) has shown appreciation.

Depreciation of Domestic currency :- It occurs when the value of our currency decreases in relation to the value of other currencies.

For Eg : If US \$ exchange for Rs. 40 instead of Rs. 38 then the domestic currency (Indian Rupees) has shown depreciation.

Foreign exchange Market :- It refers to the market for national currencies of different countries in the world. It is a centre of trade for different currencies.

Functions :

- Transfer function:- It implies transfer of purchasing power in terms of foreign exchange across different countries of the world.
- Hedging function:- It implies protection against the risk related to variations in foreign exchange rate.
- Credit function :- It implies provisions of credit in terms of foreign exchange for the export and import of goods and services across different countries of world.

Operation of foreign exchange market:-

1. Spot market :- It is the market which handles only spot transaction or current transactions.
 - It is of daily nature.
 - It does not trade in future deliveries.

Spot rate of exchange or current rate of exchange is that rate which happens to prevail at the time when transactions are incurred.

2. Forward market :- It is that market which handles such transactions which are meant for future delivery.
- It deals with forward transaction only.
 - It defines or determines forward exchange rate i.e. the exchange rate at which forward transactions are to be honored.

Forward transactions are contracted for :

- 1) To avoid the risk of any adverse change in exchange rate
- 2) To make speculative gains.

Hybrid or alternative systems of Exchange rate :-

These are those system of exchange rate which are neither fully fixed system nor fully flexible system. It combines the merit of both fixed and flexible system of exchange rate.

- 1) Wider brands
- 2) Crawling Peg.
- 3) Managed floating

- Wider brands :- It is a system that allows wider adjustment in the fixed exchange rate system. It allows adjustment up to 10% around the parity between any two currencies in the international money market.

For Eg : 1US \$ = Rs. 50, then 10% revision (upward or downward) is allowed in this exchange rate .

$$1:50 + 1\% = 1:55$$

OR

$$1:50 - 10\% = 1:45.$$

- Crawling Peg :- It allows small but regular adjustments in the exchange rate for different currencies. Not more than ($\pm$) 1% adjustment is allowed at a time. It is a small adjustment.

OR

It is a scheme which specifies parity value of the country's currency permitting a variation of 1%.

- Managed Floating :- It is a system that allows adjustments in exchange rate according to a set of rules and regulations which are officially declared in the foreign exchange market. There is no pre-defined range of adjustment and no pre-defined time of adjustment .

Dirty Floating :- It is a situation when managed floating is exercised without caring for the rules and regulations. It occurs when one country manipulates exchange rate against the interest of other country.

Purchasing Power Parity (PPP) :- It means rate of exchange in different countries is determined by the ratio of the purchasing power of their respective currencies. It is of two types :

- a) Absolute PPP :- It means that exchange rate between two countries is equal to the ratio of the price levels in the two countries.

$$R = \frac{P_A}{P_B}$$

R = rate of exchange.

P_A = Price level in country A

P_B = Price level in country B

- b) Relative PPP :- It is the ratio between the price level of two countries which accounts for the difference in the ratio of inflation in the two countries