FOREIGN EXCHANGE RATE

Rate of exchange refers to the rate at which one currency can be exchanged for another. When two countries are on the gold standard, the exchange rate will vary only between very low and very high rates.

Exchange Rate and Adjustments:

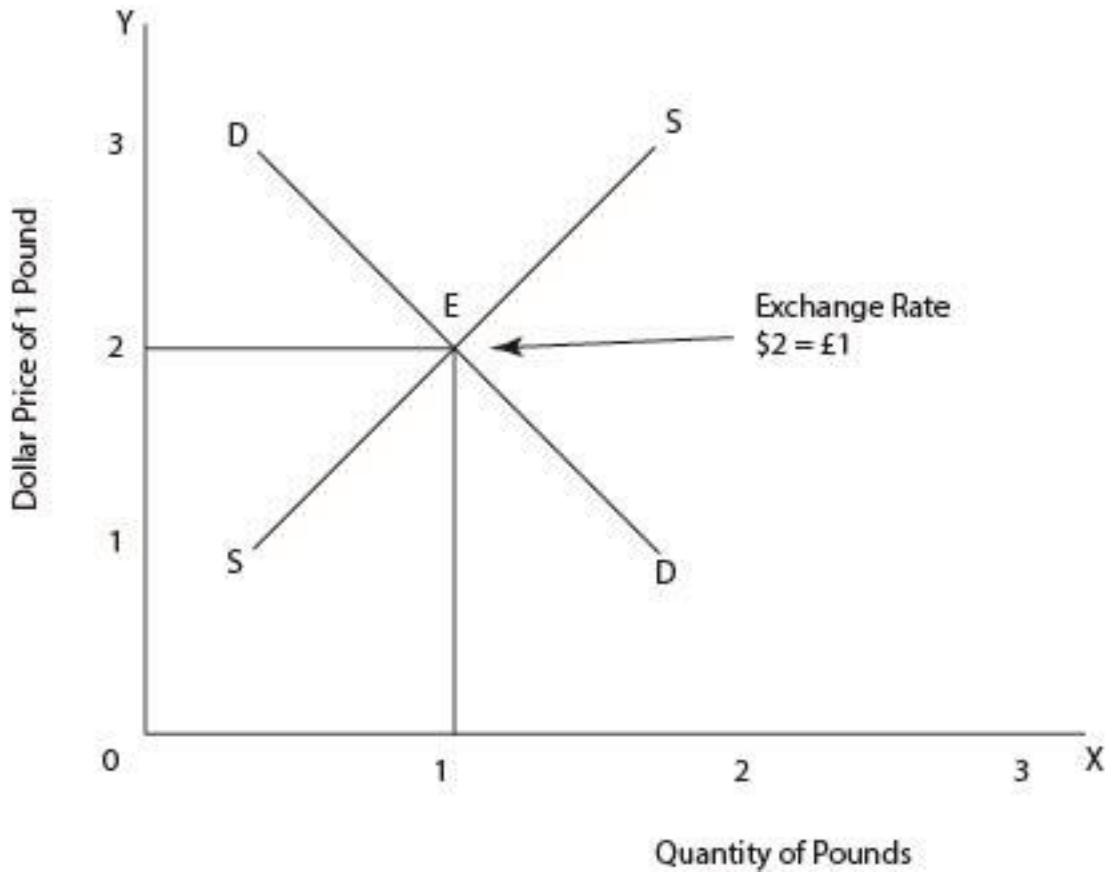
Imbalances in the balance of payments, deficits or surpluses, need adjustments sometimes on internal and other times on external grounds. Adjustments depend on the system used for this purpose. Adjustments are made using one of the two polar options, namely, 'floating' and 'fixed/pegged' exchange rates. Under the floating exchange rate system, rate of exchange between the two currencies is determined by free forces of demand supply. In the fixed system, government's intervention or any other mechanism is used to determine the rate of exchange of setting the influences of demand and supply forces.

Floating Exchange Rates:

Determination of rate of exchange between the currencies of two countries under free floating system can be illustrated by the following diagram, in which America and Great Britain exchange mutually USD and GBP.

The falling demand for pounds shown by DD shows that the less expensive pounds for Americans will make British goods cheaper. Cheapness of the goods will increase the demand in USA and the Americans will have more demand for GBP.

Curve SS in the diagram depicts that as the dollar prices of pound rises or the pound price of dollar falls, the British will purchase more US goods.



At higher dollar price for pounds, the British can have more American goods per pound. In this way, American goods for British people will become cheap and therefore, they will have more demand for American goods. To purchase American goods, British will supply pounds to foreign exchange market so that they may exchange pounds for dollars to buy US goods.

The dollar price of pound is determined at point E ($2=£1). Where demand and supply curve for pound and sterling intersect each other if the dollar price for pound increases (assume from $2 to $3 = £1) the value of dollar will depreciate relative to the pounds. Currency depreciation means that it takes more units of a currency (here dollars) to buy a single unit of some foreign currency (here pound). Reciprocal will be the analysis if dollar price of pound is assumed to be decreased. In other words, appreciation of one currency means the depreciation of any foreign currency and vice versa.

Determinants of Floating Exchange Rate:

A question of paramount importance arises here that why do the demand for and supply of a particular currency varies or why does the rate of exchange vary in favour or against? The change in the rate of exchange under free floating system can take place because of the following reasons:

1. Change in Tastes:

Change in exchange rate is followed by the change in people's tastes and preferences for a product, esp. of commonly used product like technology. For example, if the automobile technology of Japan appreciated in Great Britain, British will supply more pounds to purchase dollars. Consequently, the dollar's value will appreciate and the rate of exchange will move in favour of USA.

2. Relative Income Change:

Rapid growth of national income of a nation depreciates its currency against the currencies of other countries because it imports vary directly with its level of income.

3. Relative Price Changes:

If the prices in the domestic markets increase rapidly but remain constant in other country, the local buyers will have more demand for low-priced countries' goods. Importing country will have more demand for the exporting country. Consequently, the dollar's value will depreciate.

4. Relative Real Interest Rates:

If the money supply, by tight money policy, is restricted, the real interest rate increases in a particular economy. Consequently, other country's (e.g. Great Britain) firms and individuals find it more profitable to invest in such country where the money supply has deflated. As a result, the value of currency of this country will appreciate.

5. Speculations:

If it is speculated that in country X, growth and inflation will be faster and real interest rates will be lower in future as compared to country, the currency of X will be expected to be depreciated and conversely the currency of Y will be appreciated. Holders of X's currency will convert it into the currency of Y, increasing the demand for its currency.

<u>Demerits of Floating Exchange Rate System:</u>

Freely floating system, no doubt, works automatically but it can create some problems also given as under:

1. Free floating exchange rate system is ***highly uncertain*** which obviously make the trade profits also uncertain. Uncertainty discourages trade and so the volume of international trade shrinks to minimum.

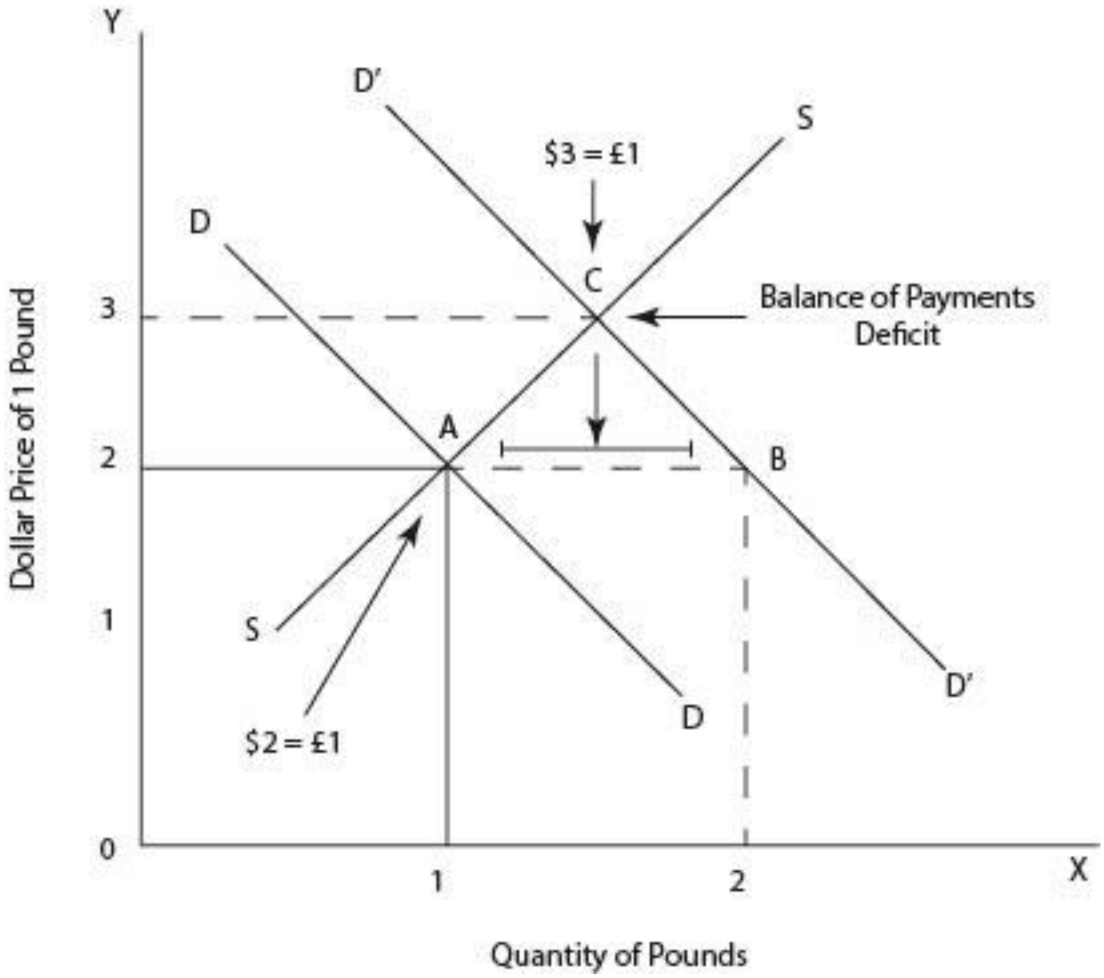
2. Decline in the external value of local currency ***worsens the terms of trade*** of a particular country. Consequently, such a country will have to give more goods for the same imports.

3. Since the fluctuating exchange rates ***depress the industry,*** which produces the internationally traded goods, as a result, ***destabilizing effects*** are casted on the economy.

Fixed Exchange Rates:

Fixed exchange rate refers to the rate where the exchange rate between two or more countries does not vary or at least varies only within narrow limits. It is also termed as pegging when the monetary authorities of the country decide to maintain or peg the rate of exchange of their currency at a fixed rate. Fixed system, sometimes, is used to counter the disadvantages of floating system.

The problem of fixed exchange rate can be understood by an example illustrated in the following diagram:



Assume that the United States and Britain agree to maintain a $2=£1 exchange rate. According to diagram, original demand for and supply of pound are DD and SS. If the American demand for pound shifts to D'D', American payment deficit arises equal to AB. It means that the American government is committed to an exchange rate of $2=£1 which is below equilibrium rate ($3=£1) of exchange. The US government can overcome the shortage of pound by altering market demand or supply or both so that they continue to intersect at the $2=£1 ratio of exchange. This purpose can be achieved through various means.

Pegging Methods:

The demand for and supply of a foreign currency can be moved in favour as mentioned below:

1. ***Manipulation of the market*** through the use of official reserves is the most desirable method to peg the rate of exchange.

2. ***Trade policies can also be utilised for pegging***. For doing so flows of trade and finances are controlled directly. Imports can be reduced by imposing tariffs and quota system. Similarly, special taxes may also be levied on nation who receives interest or dividends on foreign investment. But this option may decrease the volume of trade.

3. ***Exchange rationing*** is another method. Under this system, the government acquires the total foreign exchange itself and so control the inflow and outflow of the foreign exchange. Under this option, all the local exporters are required to sell their foreign exchange earned through exports to the government. Then the government imposes rationing on this stock of foreign currency.

4. The final method of pegging is ***domestic macro adjustment***. According to this method, local monetary and fiscal policies are used to eliminate the shortage of the required foreign currency.

Exchange Control:

Exchange control system is an antidote of free floating exchange rate system.

Objectives of Exchange Control:

The main objective of exchange control is to keep rate of exchange at a level different than that of determined by free play of demand and supply forces in the foreign exchange markets. Other objectives are mentioned as under:

1. Conservation of diminishing gold reserves in the country.

2. Ensuring stable economic growth.

3. Correction of an adverse balance of payments position.

4. Maintenance of stable exchange rate.

5. Prevention of flight of capital from the country.

6. Piling up the foreign exchange reserves for paying large amounts, like repayment of foreign aid.

Bretton Woods conference’s major contribution was the establishment of International Monetary Fund (IMF). It still administers the international monetary system and operates as a central bank for all the central banks. The member nations subscribe by lending their currencies to the IMF; the IMF then relends these funds to help the countries in balance of payments difficulties. The IMF has played a key role in organising a cooperative response to the international debt crisis.

The members of the IMF had first to announce the parity of their currencies, theoretically in terms of gold, actually in terms of US dollars, after which there were to be restrictions on changes of parity, although a change in value up to 10% could be made merely by announcing this fact to the IMF. For a change greater than 10% permission had to be given by the IMF, a decision having to be given within 72 hours when the desired change was less than 2%.

One of the objectives of IMF was to promote and stimulate multilateral trade, and it was expected that all currencies would be made convertible after a short transition period. It was hoped that the stability of exchange rates associated with the gold standard, would be achieved but with greater flexibility than that standard provided. The IMF created a pool from the contributions of members, the amount of each country's contribution depending on quota assigned to it, 75% of the contributions being in its own currency and the remainder being either in gold or partly in gold and partly in USD. The purpose of the pool was to enable a country with a temporary deficit in its balance of payments to obtain from the IMF foreign currency in exchange for its own up to a maximum of 25% of its quota in only one year, but if at any time the IMF has a supply of a members currency equal to double its quota, foreign currency can be obtained from the Fund by the country concerned only in exchange for gold.

The member country, facing imbalances on its balance of payments temporarily, is given a period to put the things in order. In 1958, the IMF agreed to issue SDRs (Special Drawing Rights) to supplement members' reserves. After the introduction of floating system, the importance of gold for valuation of the currencies has been reduced. The IMF, therefore, decided to sell most of its holdings of gold.

Source: Saeed Ahmed Siddiqui