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A monthly publication from South Indian Bank

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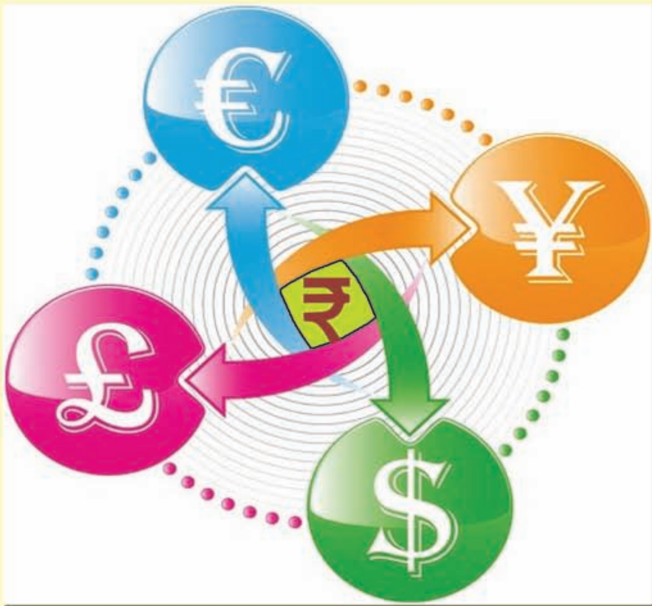

OCTOBER 2018

Theme 323

"FOREIGN EXCHANGE RATE"

27th Year of Publication

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Theme No: 323: "**Foreign Exchange Rate**"

A well informed customer will make the policy makers as well as organizations which produce goods and render services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of its products.

The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly meeting of the "Forum". The topic of discussion for this month is "Foreign Exchange Rate".

Every year local currencies across the world face intense pressure in the forex market. This pressure has a direct link to the US controlled global financial system. This is mainly due to the emergence of US dollar as centre of global finance. Let us understand how US dollar became king of global finance. Countries were struggling to find the best way to settle the trade balance. Finally countries agreed to settle trade deficits through the exchange of gold. Member countries in the Bretton woods agreement agreed to maintain a fixed exchange rate which could be adjusted if deficits or surpluses persisted. The price of gold was fixed at $ 35 per ounce. The US agreed to supply gold at this price in exchange with dollars held by other countries. The "gold for dollar" system worked during 1950 – 70. But it came under strain as gold supply was finite, where as the dollar printing had no limits. Hence the linking of gold to dollar came to an end in 1971.

What is exchange rate and why is it required?

A domestic trader selling goods in the domestic market will receive payment in terms of the domestic currency. But if the trader wants to export to the international market he will receive payment in foreign currency i.e., in Dollar or Pound or Euro which he has to convert into the domestic currency i.e., Indian Rupee. To facilitate this exchange form, banking institutions play a role. The trader will go to a bank for domestic currency. The bank will then quote the day's exchange rate i.e., TT buying rate - the rate at which Indian rupee is paid to customer in exchange of foreign currency and when the customer buys foreign currency in exchange of Indian rupee the bank quotes TT selling rates.

An exchange rate is the rate at which one currency is exchanged for another. Thus, an exchange rate can be regarded as the price of one currency in terms of another. An exchange rate is a ratio between two currencies. If 5 UK pounds or 5 US dollars buy Indian goods worth Rs. 400 and Rs. 250 respectively then pound-rupee or dollar-rupee exchange rate becomes £1 = Rs. 80 or $1 = Rs. 50. Exchange rate is usually quoted in terms of rupees per unit of foreign currencies. Thus, an exchange rate indicates external purchasing power of money.

Briefly explain the types of exchange rate system.

There are three types of exchange rate system:

a. **Flexible / Floating Exchange Rates**

   When the exchange rates are determined by the foreign exchange market, such rates are called flexible exchange rates. The exchange rates fluctuate on a moment-to-moment basis. Flexible exchange rates move based on what the foreign exchange market thinks the currency is worth. Those judgments depend on a lot of factors. The three most important are the Central Bank's interest rates, the country's debt levels, and the strength of its economy due to which the demand and supply of the foreign currency fluctuate.

b. **Fixed Exchange Rates**

   When a country's currency doesn't vary according to the forex market, it has a fixed exchange rate. The country makes sure that its value against the dollar, or other important currency, remains the same. It buys and sells large quantities of its currency and the other currency to maintain that fixed value.

For example, China maintains a fixed exchange rate. It pegs its currency, the yuan, to a targeted value against the dollar. The country which follows this system will have the advantage in terms of making its product more competitive in the International market. The United States spends more on buying Chinese goods than it makes by selling American made products to China. As a result, China's volume of exports to the United States largely outweighs its American imports.

c. **Managed floating exchange rate**

It refers to a system in which Foreign Exchange Rate is determined by market forces and the Central Bank influences the exchange rate through intervention in the foreign exchange market. India has this type of exchange rate system. During extreme fluctuations, the Central Bank under a managed floating exchange rate system intervenes in the foreign exchange market. Objective of this intervention is to minimise the fluctuation in the exchange rate of rupee.

What is foreign exchange market?

The Indian exporter sells goods, where the price of goods is quoted in foreign currency. The Indian exporter then receives foreign currency and the foreign currency is sold in exchange for rupees. If instead the Indian exporter is to be paid in Indian rupees, the importer is required to arrange for Indian rupee by sale of his foreign currency. In the former case the Indian exporter initiates a transaction that produces a credit in the Balance of payments accounts i.e., it produces sale of foreign currency and a purchase of Indian rupee. Similarly, in the case of an import transaction, the Indian importer initiates a transaction that has a debit impact in the Balance of payments accounts i.e., it produces purchase of foreign currency and sale of Indian rupee. This purchase and sale of foreign exchange is conducted in the foreign exchange market.

What do you mean by effective exchange rate?

The value of a currency is measured by the effective exchange rate, which is a weighted average of the value with respect to all other currencies, where the weights are usually determined by the relative importance of trade with each of the respective nations.

Briefly explain the term arbitrage in terms of exchange rate.

Each currency has an exchange rate with respect to other currencies. The currency can be purchased in many different financial centers. The cost of any one currency is the same in all locales due to arbitrage (riskless gain that requires no funds). If the U.S dollar cost of a pound is lower in Paris than the U.S. dollar cost of a pound in London, then arbitragers will buy pounds in Paris and simultaneously sell them in London, profiting from the difference. The act of buying in the cheap market will cause the cheap rate to rise, and the act of selling in the expensive market will cause the expensive rate to fall, until the rates are identical except for very small transaction costs. Arbitrage can also occur across three or more financial centers (triangular arbitrage). If Dollars bought with Euro in Paris can be converted to pound in New York more cheaply than directly using Dollars to buy Pound in London, then arbitragers can profit from the difference, and will cause rates to be consistent everywhere in the world.


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