



## CHAPTER - 9 : INTERNATIONAL TRADE

### UNIT-4 EXCHANGE RATE AND ITS ECONOMIC EFFECTS

#### ■ The Exchange Rate

A foreign currency transaction is a transaction that is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

- (a) Buys or sells goods or services whose price is denominated in a foreign currency.
- (b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.
- (c) Becomes a party to an unperformed forward exchange contract; or
- (d) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

#### ■ The Exchange Rate Regimes

There are 3 broad categories of exchange rate systems.

- (1) In one system, exchange rates are set purely by private market forces with no government involvement. Values change constantly as the demand for and supply of currencies fluctuate. (floating exchange rate system)
- (2) In another system, currency values are allowed to change through market forces of demand and supply but governments participate in currency markets in an effort to influence those values (managed floating / soft peg / dirty floating)
- (3) Finally governments may seek to fix the values of their currencies, either through participation in the market or through regulatory policy. (Pegged/hard peg)

**AN EXCHANGE RATE REGIME** is the system by which a country manages its currency with respect to foreign currencies. It refers to the method by which the value of the domestic currency in terms of foreign currencies is determined. There are two major types of exchange rate regimes at the extreme ends; namely

- (I) floating exchange rate regime (also called a flexible exchange rate), and
- (II) fixed exchange rate regime

#### ■ Free Floating Exchange Rate System

- (1) A free floating system has the advantage of being self-regulation
- (2) There is no need for government intervention if the exchange rate is left to the market
- (3) The primary difficulty with free-floating exchange rates lies in their unpredictability
- (4) Contacts between buyers and sellers in different countries must not only reckon with possible changes in prices and other factors during the lives of those contracts, they must also consider the possibility of exchange rate changes.

### ■ **Managed Float Systems**

Governments and central banks often seek to increase or decrease their exchange rates by buying or selling their own currencies.

### ■ **Fixed Exchange Rates**

In a fixed exchange rate system, the exchange rate between two currencies is set by government policy.

#### **In an open economy, the main advantages of a fixed rate regime are:**

1. A fixed exchange rate avoids currency fluctuations and eliminates exchange rate risks & transaction costs
2. A fixed exchange rate can thus, greatly enhance international trade and investment.
3. A reduction in speculation on exchange rate movements
4. A fixed exchange rate system imposes discipline on a country's monetary authority and lower levels of inflation.
5. The government can encourage greater trade and investment as stability encourages investment
6. Exchange rate peg can also enhance the credibility of the country's monetary-policy
7. However, in the fixed or managed floating exchange rate regimes (where the market forces are allowed to determine the exchange rate within a band), the central bank is required to stand ready to intervene in the foreign exchange market and, also to maintain an adequate amount of foreign exchange reserves for this purpose.

### ■ **A floating exchange rate has many advantages:**

- It allows a Central bank and/or government to pursue its own independent monetary policy.
- It allows exchange rate to be used as a policy tool: for example, policy-makers can adjust the nominal exchange rate to influence the competitiveness of the tradable goods sector.
- As there is no obligation or necessity to intervene in the currency markets, the central bank is not required to maintain a huge foreign exchange reserves.

#### **The greatest disadvantage of a flexible exchange rate regime is**

That volatile exchange rates generate a lot of uncertainties in relation to international transactions and add a risk premium to the costs of goods and assets traded across borders

### ■ **Nominal Versus Real Exchange Rates**

The real exchange rate is the rate at which a person can trade the goods and services of one country for the goods and services of another.

$$\text{Real exchange rate} = \text{Nominal exchange rate} \times \frac{\text{Domestic Price Index}}{\text{Foreign Price Index}}$$

The Real Effective Exchange Rate (REER) is the nominal effective exchange rate (a measure of the value of a domestic currency against a weighted average of various foreign currencies) divided by a price deflator or index of costs.

$$\text{REER} = \text{NER} \times \frac{1}{\text{Price Deflator}} = \left( \frac{\text{NER}}{\text{Price Deflator}} \right) (\text{Cost Index})$$

■ **The Foreign Exchange Market**

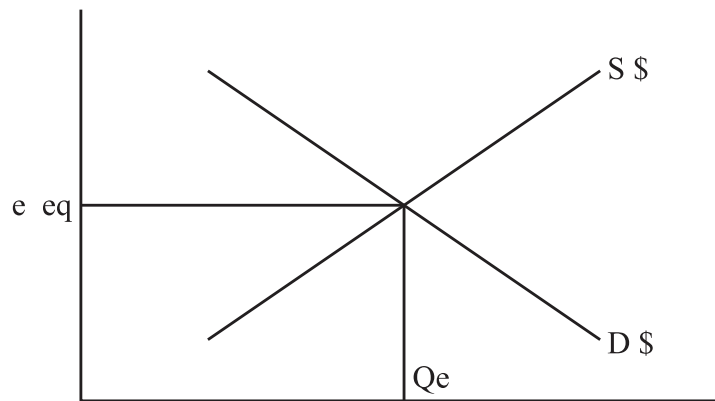
Commercial Banks and Brokerage Houses do not only execute currency exchange operations at prices set by other active players but come out with their own prices as well, actively influencing the price formation process and the market life. That is why they are called MARKET MAKERS.

**In the foreign exchange market, there are two types of transactions**

- (i) Current transactions which are carried out in the spot market and the exchange involves immediate delivery, and
- (ii) Future transactions wherein contracts are agreed upon to buy or sell currencies for future delivery which are carried out in forward and/or futures markets On account of its critical role in the forex markets, the dollar is often called a 'vehicle currency'

■ **Determination of Nominal Exchange Rate**

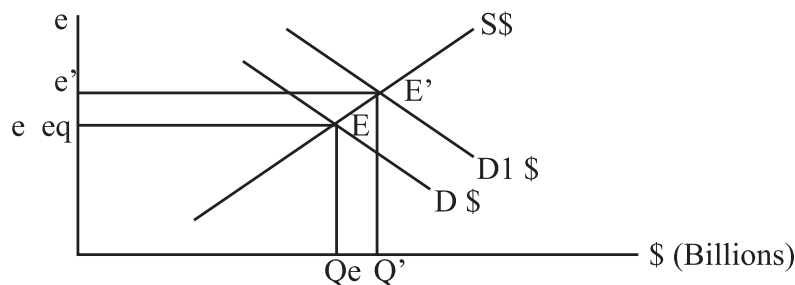
**Determination of Nominal Exchange Rate**



■ **Changes In Exchange Rates**

Currency appreciates when its value increases with respect to the value of another currency or a basket of other currencies. On the contrary, currency depreciated when its value falls with respect to the value another currency or a basket of other currencies

**Currency Depreciation under Floating Exchange Rates**





## ■ Devaluation (Revaluation) Vs Depreciation (Appreciation)

- DEVALUATION is a deliberate downward adjustment in the value of a country's currency relative to another country's currency or group of currencies or standard.
- In contrast, DEPRECIATION is a decrease in a currency's value (relative to other major currency benchmarks) due to market forces of demand and supply under a floating exchange rate and not due to any government or central bank policy actions.
- Revaluation is the opposite of devaluation and the term refers to a discrete official increase of the otherwise fixed par value of a nation's currency.
- Appreciation, on the other hand, is an increase in a currency's value (relative to other major currencies) due to market forces of demand and supply under floating exchange rate and not due to any government or central bank policy interventions

## ■ Impacts of Exchange Rate Fluctuations on Domestic Economy

- (i) Fluctuations in the exchange rate have significant role in determining the nature and extent of country's trade
- (ii) Fluctuations in the exchange rate affect the economy by changing the relative prices of domestically-produced and foreign-produced goods and services.
- (iii) Exchange rate changes affect economic activity in the domestic economy. A depreciation of domestic currency primarily increases the price of foreign goods relative to goods produced, in the home country and diverts spending from foreign goods to domestic goods.
- (iv) For an economy where exports are significantly high, a depreciated currency would mean a lot of gain.
- (v) Depreciation is also likely to add to consumer price inflation in the short run, directly through its effect on prices of imported consumer goods and also due to increased demand for domestic goods.
- (vi) The fiscal health of a country whose currency depreciates is likely to be affected with rising export earnings and import payments and consequent impact on current account balance.
- (vii) Companies that have borrowed in foreign exchange through external commercial borrowings (ECBs) but have been careless and did not sufficiently hedge these loans against foreign exchange risks, would also be negatively impacted as they would require more domestic currency to repay their loans
- (viii) Countries with foreign currency denominated government debts, currency depreciation will increase the interest burden and cause strain to the exchequer for repaying and servicing foreign debt. Fortunately, India's has small proportion of public debt in foreign currency.
- (ix) Exchange rate fluctuations make financial forecasting more difficult for firms and larger amounts will have to be earmarked for insuring against exchange rate risks through hedging.
- (x) With growth of investments across international boundaries, exchange rates have assumed special significance. Investors who have purchased a foreign asset, or the corporation which floats a foreign debt, will find themselves facing foreign exchange risk.
- (xi) Foreign investors are likely to be indecisive or highly cautious before investing in a country that has high exchange rate volatility.



■ **An appreciation will have the following consequences on real economy:**

- (i) An appreciation of currency raises the price of exports and, therefore, the quantity of exports would fall.
- (ii) The outcome of appreciation also depends on the stage of the business cycle as well. If appreciation sets in during the recessionary phase, the result would be a further fall in aggregate demand and higher levels of unemployment.
- (iii) An appreciation may cause reduction in the levels of inflation because imports are cheaper.
- (iv) With increasing export prices, the competitiveness of domestic industry is adversely affected and therefore, firms have greater incentives to introduce technological innovations and capital-intensive production to cut costs to remain competitive.
- (v) Increasing imports and declining exports are liable to cause larger deficits and worsen the current account.
- (vi) Loss of competitiveness will be insignificant if currency appreciation is because of strong fundamentals of the economy.