4.DETERMINATION OF EXCHANGE RATE:

Unit Structure:

4.1. Learning Objectives.
4.2. Introduction.
4.3.Factors affecting exchange rate.

4.1. LEARNING OBJECTIVES:

After studying this lesson you are able to:

- Understand various factor the exchange rate
  affecting determination

4.2. INTRODUCTION:

Each and every currency carries a price just like any goods that are traded. This price keeps going under reasonable changes over a short period of time. For example, During the Asian financial crisis in 1997Thai baht lost 56% of its value in a short period of about six months.

Whereas at times, a country's currency may remain relatively stable to other currencies over a longer period of time. For example, the Chinese Yuan since January 1994 has not fluctuated outside a range of 8.0-8.8 Yuan/US$.

The explanations for the sudden extreme currency fluctuations or prolonged stability are not always so likely to be understood. However, an understanding of the factors influencing exchange rates daily is by far much more difficult to come by.

The determinants of prices in any market are rarely clear. Countless theories have been developed to explain variations in exchange rates, but none was considered as law. The foreign exchange market, with 193 participating countries and US$ 1.9 trillion in daily turnover, is far too complicated to be described neatly by a set of formulas or theories. Keeping in mind the ambiguous nature of the foreign exchange market, Alan Greenspan, the former U.S. Federal Reserve Board Chairman once said, "There may be more forecasting of exchange rates, with less success, than almost any other economic variable."

To sum it up is can say that foreign exchange rate can be defined as the value of a country’s currency with regards to another country’s currency. It therefore two aspects.i.e. 1) The domestic currency aspect and 2) the foreign currency aspect. This rate will never be constant but varies from period to period depending on the changes in the international market. These changes in the market are usually brought about by the market factors of demand and supply of currencies between countries. It is therefore very important we understand the factors that affect exchange rates when receiving and sending money from abroad.

In this section we analyze some of the vital factors that play a major role in determining the exchange rate of a particular country.

4.3 FATCTORS AFFECTING FOREIGN EXCHANGE RATES:

Foreign Exchange rates are influenced by several factors in the global market. The net disequilibrium in the BOP represented that the single most important element affecting an exchange rate is demand supply. These are represented by Tangible Factors noted in BOP, since their impact can be quantified. But further studies have shown that, 90% of the volume in the foreign exchange market is made of speculative transactions, which are transactions without any underlying commercial base. These transactions are undertaken in anticipation of future changes in demand or supply. Factors which influence the trading decisions of speculators are called intangible factors since their impact cannot be quantified.

Hence various factors which influence the exchange rate can be summarized as follows:

1. INFLATION:

Inflation is the rate of change the price level of good and services in the economy. Inflation rates variation in the market is one of the crucial factors that affect the exchange rate of a country. Practically, a country which has a continues low inflation rate will have a stronger value of the currency compared to those countries with inflation rates high, with other factors being constant. In countries where there is low rate of inflation, the market value of goods and services in those countries will usually appreciate at a relatively slow rate compared to countries with higher inflation rates. The value of the currency appreciates steadily when the low inflation rates are experienced for a longer period of time. Whereas on the other hand, countries high on inflation rates for a prolonged period of time usually have interest rates high on goods and services offered and at the same time experiences constant depreciation in the value of their currency.

2.INTEREST RATE DIFFERENTIALS:

Interest rates, inflation rates and foreign exchange rates are always co- related and play a vital role in determining the stability of the market environment. Any slight changes in the rate of interest will definitely affect the value of the currency and its exchange rate in the foreign market. Interest rate to a currency has a dual impact on the currency valuation. If increase in the interest rate suggests the strength of the economy then it would have a favorable effect on the exchange rate. However if there is increase in the interest rates due to expectations of higher inflation then it would have an adverse effect on the value of the currency. There are always two currencies involved in any exchange rate. Therefore there might be situations where the interest rates of both currencies may rise at the same time. In such situations the interest rate differential is obvious. Sometimes the smallest rates of the two currencies could move in opposite directions resulting in widening the gap between the two. In such cases the effect on the exchange rate would be more distinct.

3. BALANCE OF PAYMENTS (BOP) OR A COUNTRY'S CURRENT SAVINGS AND INVESTMENTS:

A country management towards maintaining balance between trade and the earnings got from foreign investments is very crucial in determining the exchange rate. This information can be obtained in the current account of BOP which contains the sum total of all transactions done by the government including exports and imports. When the government spends more on imports as compared to the export earnings, it will create a deficit in its current account. This kind of deficit causes reduction in the value of domestic currency causing disequilibrium in the balance of payments. In such a situation volatility and unpredictability of the exchange rate of the domestic currency becomes highly noticeable.

4. GOVERNMENT DEBT:

Unpaid dues created by the central government are always considered to be a liability in general and a public debt in specific. The bigger the debt the less likely the government is able to get foreign capital. This will result in increased inflation in the country. When the debts are too high most of investor will opt to trade their bonds. This will lead to a fall in the value of the current exchange rate.

5. TERMS OF TRADE:

Terms of trade are the ratio of export prices to import prices of a country. This ratio affects the balance of payments (BOP). The terms of trade are favorable if the export prices are higher than the import prices or when the export price rise at a faster rate than the import price. The effect generates higher revenue for the country. The domestic currency therefore will have a higher demand and the local currency appreciates in value. All this leads to to an increase in the value of the exchange rate.

6. POLITICAL FACTOR:

Politics in a country will always affect its economic performance. A country that experiences severe political unrest is always considered risky for foreign investors. This diverts the foreign investment to those countries that are politically stable. Safe and sound trade agreements between countries attract more foreign investments which lead to increased foreign capital. A country fixed with constant political unrest and political instability attracts a lot of uncertainty in the Forex market leading to depreciation of the exchange rate for its currency.

7. ECONOMIC RECESSION:

Recession in economic activity of a country will lead to a decline in interest rates. This will reduce the chances of the country to get foreign capital. This will eventually lead to the domestic currency becoming weak in relation to foreign countries and therefore decreasing the value of the foreign exchange rate.

8. SPECULATION:

This is more of a sit and sees approach of foreign exchange. More than 90% of the turnover in global foreign exchange market represents speculative activities. If the trader on his own instinct feels that in the near future a certain currency will increase in value, then he will buy that currency at the prevailing lower rate now. Then he will wait till the value increases so that he can sell it at more value than what he bought it for. This eventually will increase the exchange rate.

9. DEMAND – SUPPLY:

In the context of floating exchange rates, foreign exchange rate should be determined by forces of supply and demand. The objective of floating exchange rates is to correctly incorporate all the factors that influence the demand for and the supply of currency. For commodities represented by foreign currencies, the spot exchange rate is influenced by expectations regarding the future changes in the price and these expectations are in turn influenced by economic events, resource discoveries, technological developments, political developments, etc. Demand for any given currency in the international markets arises from individuals and corporate entities who undertake foreign currency transactions and central banks that hold a part of their reserves in that currency. Similarly, supply of the foreign currency arises out of nonresidents wishing to buy domestic country goods and services, acquire domestic currency denominated assets, etc. Exchange rate is the equilibrium price that equates these factors.

The Balance of Payment theory of Exchange Rate determination is therefore the connecting link between demand and supply of foreign exchange due to current account transaction, the assets and liabilities values represented in the capital account and Reserve and Surplus account which helps in balancing the net surplus or deficit.

In conclusion, all the above factors affect foreign exchange rates. This information is particularly important for people who often send and receive money as it will help them determine the best time to do so. It is also important to know how to cushion yourself against such fluctuations.