Exchange Rates- Things You Need To Know

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Introduction

The exchange rate is the price of a country's currency in terms of another country's currency.

How to calculate Exchange rate?

- It is calculated by relating the value of one currency to other country currency

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- In mathematical terms, Exchange rate = (price of domestic currency)/(price of foreign currency)
- Example: $1 = 65 rupees implies that one has to give 65 rupees to get $1

Who determines Exchange rate?

- After World War II, World Bank and IMF were formed to reconstruct the war-torn world nations
- IMF determined the exchange rate initially with the quota of the developed nations
- Later, UK withdraw from the fixed rate regime and fixed its own currency rate depending on market conditions
- Gradually, countries also started moving to the floating currency regime
- Currently, the central bank of nations have the power to determine the exchange rate by buying and selling currencies in the foreign exchange market

How to determine Exchange rate?

- To determine the exchange rate, there are three generally used methods
- Fixed exchange rate
- Floating exchange rate
- Crawling peg exchange rate

Fixed Exchange Rate

- Also called as pegged exchange rate
- Central bank of a nation fixes and maintains the exchange rate
- The domestic price of the currency will generally be set against US dollar or other world currency like Euro, Yen or IMF basket of currencies

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- Central bank will sell and buy its own currency from the foreign exchange market against the pegged currency
- RBI has been following the fixed exchange rate till 1991
- Now complete fixed exchange rate regime has come to an end and only a combination of fixed and floating rate are employed in the foreign exchange market

Floating Exchange Rate

- Floating exchange rate is determined by demand and supply prevailing in the market
- Rate determined solely by the market
- Exchange rate constantly changes periodically (even on daily basis)
- Also termed as the self-correcting exchange rate
- When the demand for a currency in foreign exchange market becomes low, then its imports become expensive and ultimately its value will decrease
- This will cause heavy demand for goods and services domestically
- This, in turn, results in the creation of more jobs domestically
- Thus an automatic correction is made balancing the demand and supply in the floating currency regime
- The exchange rate changes in global scenario will affect the domestic currency in the floating rate regime
- Currently, this is the widely accepted and adopted currency regime by the world nations

Crawling Peg Exchange Rate

- Also known as Dirty Floating rate
- This is a combination of fixed and floating exchange rate
- Government allows the currency to fluctuate freely in a given band determined by the central bank
- Once the currency exceeds the band fixed by central bank, Government intervenes in the foreign exchange market to stabilise the domestic economy

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Implications of Exchange rate

- Appreciation of exchange rate or rupee appreciation implies rise in exchange rate of rupee
- Depreciation of exchange rate or rupee depreciation implies fall in exchange rate of rupee
- Both appreciation and depreciation of currency occurs as a result of change in supply and demand of the currency in the foreign exchange market
- Depreciation of currency favours exports and makes imports costlier
- Appreciation of currency favours imports and makes exports costlier
- Devaluation of currency is similar to depreciation of currency
- India devalued its currency during the 1991 Balance of Payment crisis
- Recently China devalued its currency Yuan
- RBI has the power to devalue the rupee by selling more rupees and buying dollars from the foreign exchange market
- Similarly, RBI can revalue the rupee by selling dollars and buying rupees
- The activities of devaluation and revaluation of currency are associated with the fixed exchange rate regime

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