CHAPTER TWO

Foreign Exchange Rate: Conceptual Framework

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INTRODUCTION:
The international trade and multinational corporate are using the foreign exchange rates as economic medium to achieve their transactions but the foreign exchange rates are not stable today in the international currency markets and the fluctuation of the foreign currency not only became daily but hourly and often even by the minute since the Bretton Woods system was broken in 1971. The foreign currency fluctuation also, became problem in international accounting. Thus, this chapter is devoted to discuss the fundamentals of foreign exchange to understand the nature of this economic phenomena and the affecting factors and the development of the international exchange system.

Exchange Rate:
The major’s currencies of the world are traded in many places and in many ways. An exchange rate is the prices of one currency relative to another, that is, how much of one currency it takes to buy so much of another currency. The exchange rate of any currency refers to its external value, i.e., its purchasing power of the currency against another currency. Thus, the exchange rate is the ratio for exchange of two currencies (IASC, 2001, IAS21:577).

The exchange rate affected by the following factors (Mueller, et al, 1994; Belkaoui, 1994):

- Relative rates of inflation, currency of countries with higher rates of inflation, depreciate relative to the currencies of countries with lower levels of inflation. Generally speaking, inflation means that one is able to buy less and less of every thing (including another country’ currency) for a fixed amount of one’s own currency.
• Balance of payments surpluses or deficits when a country exports more than it imports, it is said to run a trade balance of payments surplus. Surpluses cause the nation’s currency to appreciate in value (i.e., to strengthen). The opposite conditions—trade deficits—cause a currency to command less of other nation’s currencies.

• Relative interest rates. Whenever one nation has higher interest rates relative to other nations its currency appreciates in value. (Foreigners purchase more of its currency in order to invest in and earn the higher interest)

• Money supply: An increase in money supply in the country will affect the exchange rate through causing inflation in the country. It can also affect the exchange rate directly.

• National income. An increase national income will lead to an increase in investment or in consumption, and accordingly, its effect on the exchange rate will change.

• Resource discoveries. Discovery of resource by country helps its currency to gain in value. (Such as, Middle East in case of oil discovery).

• Capital movement. There are many ways factors that influence movement of capital from the country to another. Short-term movement of capital may be influenced by the offer of higher interest which can attract the foreign fund into the country and the exchange rate of the currency with rise. Right investment climate and political stability may encourage portfolio investment in the country. This leads to higher demand for currency and upward trend in its rate.

• Political factors and Government intervention political stability induces confidence in the investors and encourages capital inflow into the country. This has effect of strengthening the currency of the country. On the other hand, where the political situation in the country is a stable; it makes the investors withdraw their investments. The outflow of capital from the country would weaken the currency.

• The economic policies pursued by the Government have a great influence on the exchange rate. The major’s instrument of achieving the policies of the government is monetary policies and fiscal policies adopted. These policies affect all the factors thus for discussed, e.g., inflation, interest, etc, hence and have an effect on the exchange rates.

• Another way in which the government may affect the exchange rates is through its policy of maintaining the exchange rate. Official intervention will have the effects of smoothing the rate in disorderly market. But if the authority attempts to counter
the market’s anticipation and resist it by intervention ultimately more steep and sudden exchange rate change can occur.

- Generally speaking, for international transactions the currencies of countries considered politically stable tend to be favored over the currencies of unstable countries. Governments also may buy or sell currencies when they want to change exchange rates.

- Political stability may encourage the phenomena of speculation of foreign currencies (e.g. dollar) against national currency.

- Also the dollarization phenomena may occur, when the people’s preference trend towards using foreign currency to achieve their domestic transactions due to the unbelievable fluctuation in the national currency.

- Example, Yemen economy had witnessed these two phenomena during the political crisis (1991 – 1994).

- Psychological factors and speculation in the short-term, the exchange rate is affected by mostly by the views of the participations in the market about the likely changes in the exchange rates. The expectations are based on many factors listed above. The behavior of the major participant (market maker) in the market can affect the exchange rates.

**Conclusions:**

It would be seen that exchange rates are influenced by different factors some of the factors are inter-related, while some are independent.

Together, they decide the trend. At time, the short-term factors may take the exchange rates in opposite direction to that set by long-term factors.

At other time, the short-term factors may accentuate the trend set by long-term factors.

The efficiency of an operator in the foreign exchange market depends upon isolating the influence of these factors, so that a correct judgment about the likely changes can be made.

1. **Direct and indirect exchange rate**: Direct rate is the amount of local currency equivalent to one unit of the foreign currency. Indirect rate is amount of foreign currency required for one unit of the local currency.

2. **Free (floating) and fixed exchange rates**:
   - Free (floating) rates. Rates determined by market forces.
   - Fixed rate. Rates determined by Government. These known as official rates.

3. **Spot and forward exchange rates**:
   - Spot rate. The rate quoted for current transactions, usually for delivery within two business days.
   - Forward rates. The contractual rate between the foreign exchange trader and client for delivery at a future date.

4. **Buying and selling exchange rates**. Bid (buy) and offer (sell) rates, quoted in terms of the trader.

5. **Current (closing) and historical exchange rates**. Current (closing) rates — the rate at balance sheet date. Historical rates — the rates at transaction date.

6. **Average (weight average) and actual rates**. Actual rate (rate at transaction date)
   - Average rate is rate for the period (i.e., a week, month or year.).

**INTERNATIONAL MONETARY SYSTEMS**:

The International exchange system has passed the following stages (Gray, 1993; Apte, 2003):

**Exchange rate system prior to IMF**

Prior to the Institution of International Monetary fund, the international monetary systems were following the fixed exchange rate system based on international gold standard.

Under the gold standard the value of the currency was kept equal to the value of a fixed weight of gold. Over the years the gold standard touch there forms (a) gold currency standard, (b) gold bullion standard, and (c) gold exchange standard.
(a) Gold Currency Standard

Gold standard or gold currency standard or gold coins standard was the monetary system where gold coins of a definite weight and fineness circulated as the standard unit of currency. To a small extent paper currencies and coins of other metals like nickel and silver also circulated but they were freely convertible into gold. Gold coins could be melted and used for industrial or other purpose.

The gold currency standard could survive up to 1914 because of many facilitating factors that prevailed up to that period. Countries believed that the best policy was to keep the value of the currency constant in relation to the value of gold. They were prepared to freely allow movement of gold, even though at times it meant large-scale unemployment in the country. Free trade policy adopted by the countries helped free functioning of the mechanism. There were no hot - many movements chasing higher interest rates.

But the scene changed with the advent of the First World War. European governments ceased to allow their currencies to be convertible either into gold or other currencies, causing the collapse of the gold standard.

(b) Gold Bullion Standard

After the war, an International Conference at Brussels, in 1922, decide to reintroduce gold standard in a modified form. The results were the gold bullion standard under the gold bullion standard, paper currency replaced gold coins. But the paper currency was expressed as a definite quantity of gold certain fineness.

Gold bullions were not converted into coins. Gold acted as the reserve for the circulation. With the introduction of paper money, the purchasing power of money was divorced from the value of gold.

The interwar period witnessed rampant nationalism, prices rigidities, volatile capital movements and other impediments to international trade. Countries indulged in an open market operation to offset gold movements, thereby not allowing the gold – money relationship to functions.
They also indulged in exchange rate wars by resorting to competitive depreciation of currencies. Hot money movements characterized this period due to changes in banking policies and use of bank rate by the central banks. High tariffs were imposed on imports. Many countries faced difficulty in repayment of war debts. Because of the above factors, the gold bullion standard had to be given up. England, which adopted these systems in 1925, suspended it in 1931. America followed with the same decisions in 1933.

(e). Gold Exchange Standard

The Great depression of 1930 showed the weakness of the gold standard. The Geneva Conference suggested Gold exchange standard to conserve gold reserves. Under this standard the currency of the country consisted of paper currency and subsidiary coins. They were not expressed in terms of gold but in terms of foreign currency, which was on gold standard. Gold coins did not circulate in the country nor was gold kept as reserve for money in circulation. The monetary authorities undertook to convert in unlimited quantity the currency of the country into that of the foreign currency, which was on gold standard. For that purpose, the monetary authorities maintained foreign asset reserve, bank account, and other liquid assets in foreign country concerned.

Gold exchange standard was not new; it had existed even earlier. For instance, India adopted this standard before 1914. The value of rupee was maintained fixed in relation to pound – sterling at is 4d. Per rupee.

As we shall see presently, gold exchange standard formed the basis of the exchange rate policies of the International Monetary Fund (IMF) as it was originally implemented.

Exchange Rate System under IMF (Gray, 1993; Jeevananadam, 2002):

Original scheme under IMF

The International Monetary Fund was instituted soon after the Second World War with the avowed objective of facilitating smooth running of International trade and betterment of all nations of the world.
It was thought that a system of fixed exchange rates would be necessary for the smooth functioning of international finance.

The original scheme of the IMF, therefore, provided that:

a). Each member country should declare the external value of its currency in terms of gold and currency pegged to gold. Most countries declared values of their currencies in terms of gold and US dollar.

b). The value of US dollar was fixed at USD 35 per ounce of fine gold. The USA committed itself to covert dollars into gold at the above official price.

c). Following the above, the monetary reserve of member-countries came to consist of gold and US dollars. Thus US dollar got the position of a reserve asset.

d). Each country agreed to maintain the market value of its currency within a margin of 1% the par value. Where the variation in the market is more than the permitted level, the country should take steps to devalue the currency to correct the position.

e). Member was free to devalue their currencies. But, if the devaluation exceeded 10% of the par value, approval of the IMF should be obtained. The IMF might approve it or advice a lower rate. However, it had no power to reject the proposal.

f). The IMF granted short-term financial assistance to its members, to tide over their temporary balance of payments problems. For chronic problems the members were expected to use permanent solutions like devaluation.

**Working of the System:**

For the smooth running of the system, the major's industrialized countries, other than the USA endeavored to keep exchange rate changes to the minimum and maintain a common price level for tradable goods.

Since other countries were endeavoring to maintain the exchange rate, USA had to remain passive in foreign exchange markets so as to lend support to such efforts. On the other hand it had to follow a monetary policy that could provide a stable price level for tradable goods. Europe and Japan found it convenient to rely upon the USA to supply a stable price environment, and support US dollar as unit account and means of settlement of international transactions.

The system provides a distinct advantage to USA, via., the seigniorage gains
It means that USA could obtain goods and services from abroad by merely printing US dollar, so long as the other countries were willing to accept dollar as the key currency. The acceptance of dollar dependent on the confidence of other countries had that their US dollar reserves could be used for settlement of their international debt or that they convert than reserves into gold.

This aspect proved to be both a strength and weakness of the system. It was strength because dollar became a reserve asset, in addition to gold, providing additional base for creation of money supply to keep pace with increase in international trade. It was a weakness in the sense; the system depended excessively on a single currency. This dependence ultimately brought the fall of the system.

**Collapse of the system:**

For about two decades the system worked smoothly slowly during that late sixties, the deficiencies of the system began to surface themselves up. One of the major difficulties was that the growth of means of settlement of international debts (international liquidity) did not keep pace with the increase in the volume of international trade. Many countries began to experience balance problems. The reasons can be attributed to the fact that increase in international liquidity depended upon the availability of gold. The other reason was the undue importance given to a single currency, viz., the US dollar. As we have seen the system depended on the confidence other countries had in the US dollar. It the faith in dollar was lost due to pressure in the marker and if only a portion of the balance outside was required to be converted into gold the Federal Reserve systems of the USA would have collapse because the gold reserve constituted only a little portion of the dollar balances abroad.

The events in 1960s followed the predictions. The USA experienced heavy deficits in the balance of payments. The supply of dollar in the foreign exchange markets increased to greater extent leading to sharp fall in the value of dollar in the market.

As a corrective measure the USA was advised to devalue its currency. But the USA did not heed to the advice because it was thought the prestige enjoyed by the dollar as an international reserve currency would thereby suffer.
Further, it was thought that devaluation of dollar would affect many other countries, which had accumulated huge dollar balances. 

Instead of resorting to devaluation the USA took a unilateral and unexpected step on August 15, 1971. 

*The convertibility of dollar into gold was suspended and further a surcharge of 10% was imposed on imports into the USA.*

Some major's countries like Japan and West Germany took steps to rescue the dollar by purchasing it in huge amounts. This action could not, however, stabilize the exchange market. Therefore, some western countries decided to float their currencies in exchange market.

Smithsonian Agreement (snake in the Tunnel). This state of instability and confusion led the other countries to devote immediate attention to the issue. 

*Ten major industrialized countries* of the world (the USA, Canada, Britain, West Germany, France, Italy, Holland, Belgium, Sweden and Japan) which came to be known as the group of ten met at the Smithsonian building in Washington during December 1971 to solve the *dollar crisis* and it decided about the realignment of the currencies.

The fact that the Smithsonian Agreement was not a *panacea for the ills* was proved soon. Following the second devaluation of US dollar (i.e. on February 13, 1973), many countries including Japan, West Germany and UK, started floating their currencies. Thus the Smithsonian Agreement came to an end.

Abolition of Gold and Emergence of SDR. The committee of 20 – which had 20 principal members both from develop and developing countries – made a number of far – reaching recommendations on reforming the IMF system.

The major recommendations relate to the place of the gold in the IFM system and the use of SDR.

Second Amendment of IMF Articles. A major change in the IMF system was noticed with the second amendment to its articles of Agreement, which came into effect from April 1, 1978. Under the present arrangement every member is free to choose its own exchange rate
system. But every member should endeavour along with IMF and other members to ensure
general stability of exchange rate system and orderly conditions in exchange markets.

**Plaza – lourve Intervention Accords:**

Even though floating rate has become the order of today, the events in 1980s have lent
legitimacy to official intervention in the exchange markets to regulate exchange rates.
Between 1981 and 1985 the US dollar appreciated by over 50%.
The appreciation of dollar resulted in the country losing its export competitiveness.
European countries had to adopt stricter monetary policies to arrest fall of their currencies.
They could not take advantage of the situation to increase exports to USA, due to import
restrictions placed by the latter to protect its industries. On September 22, 1985 officials
from group of five countries (G-5- British, France, west Germany, Japan and USA) met at
plaza Hotel in New York.
After meeting the officials from G-5- countries announced that they would intervene jointly
to reverse the dollar appreciation. As an immediate reaction to the decisions, the dollar fell.
Shapely and continued to decline through 1986.

At the meeting held at lourve in Paris on February 22, 1987, G-5-countries along with
Canada, agreed to foster stability of exchange rates around the existing levels. The central
banks agreed for a set of target zones, or exchange rate ranges, that they would defend
using active foreign exchange intervention.

**The present system:**
The present system can be termed as managed float under which the major currencies are
floating but subject to exchange control regulations to keep the rate movements within
limits.
The different methods adopted at present by countries for exchange rates are
(Jeevanandam, 2002):

(a). The major currencies like the US dollar, Japanese Yen, pound - sterling, are
floating, i.e., their exchange rates are determined by market forces.
(b). Some currencies are pegged to SDR; their values move with change in the value
of SDR, e.g. Burmese kyat.
(c). Some currencies are pegged to a major currency, e.g. Sri Lankan rupee is pegged to pound sterling.

(d). For some currencies rates are based on a basket of currencies.

(e). For some currencies, rates are subject to mutual intervention arrangements.