[Frequently Asked Questions]

Factors Affecting Exchange Rates Part - 2

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Frequently Asked Questions

Q1.Name the 8 key factors that affect the exchange rates of any nation.

A1.

- Inflations rates
- Interest rates
- Government
- Country’s current account/balance of payment
- Terms of trade
- Political stability and performance
- Recession
- Speculation

Q2. Explain how Inflation Rates act as key factor affecting exchange rates.

A2. Changes in inflation cause changes in currency exchange rates. A country with a lower inflation rate than another's will see an appreciation in the value of its currency. The prices of goods and services increase at a slower rate where the inflation is low. A country with a consistently lower inflation rate exhibits a rising currency value while a country with higher inflation typically sees depreciation in its currency and is usually accompanied by higher interest rates

The rate of inflation in a country can have a major impact on the value of its currency and the rates of foreign exchange it has with the currencies of other nations. However, inflation is just one factor among many that combine to influence a country's exchange rate.

Inflation is more likely to have a significant negative effect, rather than a significant positive effect, on a currency's value and foreign exchange rate. A very low rate of inflation does not guarantee a favorable exchange rate for a country, but an extremely high inflation rate is very likely to impact the country's exchange rates with other nations negatively

Inflation is closely related to interest rates, which can influence exchange rates. Countries attempt to balance interest rates and inflation, but the interrelationship between the two is complex and often difficult to manage. Higher interest rates tend to attract foreign investment, which is likely to increase the demand for a country's currency. However, higher interest rates often cause increasing inflation rates, a negative influence on the country's currency. Low interest rates spur consumer spending and economic growth, and generally effect positively on currency value, but they do not commonly attract foreign investment.

The ultimate determination of the value and exchange rate of a nation's currency is the perceived desirability of holding that nation's currency. That perception is influenced by a host of economic factors, such as the stability of a nation's government and economy. Investors' first consideration in regard to currency, before whatever profits they may realize, is the safety of holding cash assets in the currency. If a country is perceived as politically or economically unstable or if there is any significant possibility of a sudden devaluation or other change in the value of the country's currency, investors tend to shy away from the currency and are reluctant to hold it for significant periods or in large amounts.

Beyond the essential perceived safety of a nation's currency, numerous other factors besides inflation can impact the exchange rate for the currency. Such factors as a country's rate of economic growth, its balance of trade (which reflects the level of demand for the country's goods and services), interest rates and the country's debt level are all factors that influence the value of a given currency. Investors monitor a country's leading economic indicators to help determine exchange rates. Which one of many possible influences on exchange rates predominates is variable and subject to change. At one point in time, a country's interest rates may be the overriding factor in determining the demand for a currency. At another point in time, inflation or economic growth can be a primary factor.

Exchange rates are relative, especially in the modern world of fiat currencies where virtually no currencies have any intrinsic value. The only value any country's currency has is its perceived value relative to the currency of other countries. This situation can influence the effect that an input such as inflation has on a country's exchange rate. For example, a country may have an inflation rate that is generally considered high by economists, but if it is still lower than that of another country, the relative value of its currency can be higher than that of the other country's currency.

Q3. Explain how Interest Rates act as key factor affecting exchange rates?

A3. Changes in interest rate affect currency value and dollar exchange rate. Forex rates, interest rates, and inflation are all correlated. Increases in interest rates cause a country's currency to appreciate because higher interest rates provide higher rates to lenders, thereby attracting more foreign capital, which causes a rise in exchange rates

Q4. Explain how country's Current Account / Balance of Payments act as key factor affecting exchange rates?

A4. A country's current account reflects balance of trade and earnings on foreign investment. It consists of total number of transactions including its exports, imports, debt, etc. A deficit in current account due to spending more of its currency on importing products than it is earning through sale of exports causes depreciation. Balance of payments fluctuates exchange rate of its domestic currency.

Q5. Explain how country's Government act as key factor affecting exchange rates?

A5. Government debt is public debt or national debt owned by the central government. A country with government debt is less likely to acquire foreign capital, leading to inflation. Foreign investors will sell their bonds in the open market if the market predicts government debt within a certain country. As a result, a decrease in the value of its exchange rate will follow.

Q6. Explain how country's terms of trade act as key factor affecting exchange rates?

A6. The Terms of Trade is the average price of exports / by the average price of imports. It is a measure of a countries relative competitiveness.

- If export prices rise relative to import prices we say there has been an improvement in the terms of trade. – A unit of export buys relatively more imports.
- If import prices rise relative to export prices we say there has been a deterioration in the terms of trade.

So we can say that, related to current accounts and balance of payments, the terms of trade is the ratio of export prices to import prices. A country's terms of trade improves if its exports prices rise at a greater rate than its imports prices. This results in higher revenue, which causes a higher demand for the country's currency and an increase in its currency's value. This results in an appreciation of exchange rate.

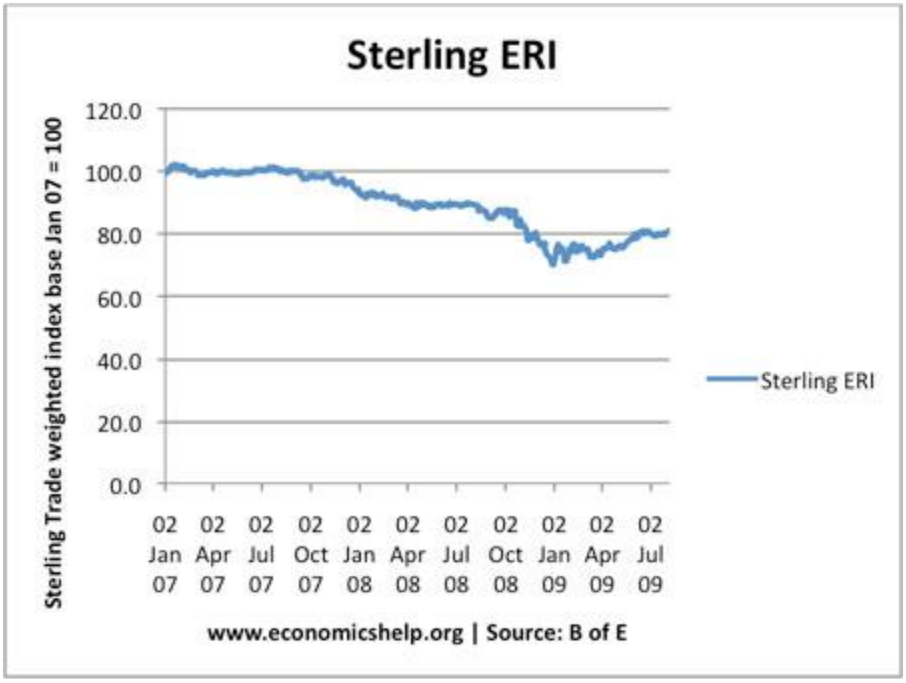
Q7. Explain how country’s political stability and performance act as key factor affecting exchange rates?

A7. A country's political state and economic performance can affect its currency strength. A country with less risk for political turmoil is more attractive to foreign investors, as a result, drawing investment away from other countries with more political and economic stability. Increase in foreign capital, in turn, leads to an appreciation in the value of its domestic currency. A country with sound financial and trade policy does not give any room for uncertainty in value of its currency. But, a country prone to political confusions may see a depreciation in exchange rates.

Q8. Explain how recession act as key factor affecting exchange rates?

A8. When a country experiences a recession, its interest rates are likely to fall, decreasing its chances to acquire foreign capital. As a result, its currency weakens in comparison to that of other countries, therefore lowering the exchange rate.

There is no hard and fast rule about what will happen to the value of a currency during a deep recession. For example, when the great recession started in 2008, the UK experienced a significant depreciation.



The Pound Sterling fell nearly 20% from 2007 (before the start of the great recession) to July 2009

But the Euro and Dollar were less affected by the great recession.

The US dollar index (which shows the value of the US dollar against a trade weighted basket of other currencies, e.g. Euro and Yen) has fluctuated but overall has remained at similar value to the start of the recession.

Note in early 1980, the US went into recession, but during this period the value of the Dollar rose.
It was a similar experience in the UK, in the 1980s, In 1980, there was a rapid appreciation in Sterling (which was one factor contributing to the recession of 1980/81.)

Q9. Explain the Economic Theory behind the value of a currency in recession taking an example.
A9. Suppose one country, e.g. the UK, enters a deeper recession than all its other competitors. How might we expect the currency to behave?
Recession and interest rates
If the UK enters a recession, then we would expect UK interest rates to fall compared to other countries. This would make the UK less attractive for investors to save money. Hot money flows are likely to leave the UK and move to countries with higher interest rates. If people move money out of the UK, they will sell Pounds and buy other currencies, causing a fall in the value of Sterling. Therefore, in theory, we might expect a recession to cause a fall in the value of the currency.
Evaluation
1. In a recession, inflation is likely to fall.
Lower inflation will help the country become more competitive and this may increase demand for the currency causing it to rise.

2. Many factors affect the value of currency.

For example, if the UK had a large current account deficit, then we might expect this trade deficit to put downward pressure on the currency. The fall in the value of Sterling in 2008 was partly related to the UK’s trade deficit and lack of competitiveness. However, if a country like Germany entered recession, they may be less downward pressure on their currency (the Euro) because Germany has a large current account surplus.

3. It depends what is happening in other countries.

During the great recession, US interest rates fell to 0%, they created money (through quantitative easing) and there were concerns about the size of the US public sector debt. Usually, all these factors (zero interest rates, printing money, high debt) would put downward pressure on the value of the dollar. However, in the great recession, most major economies also had low interest rates and high government debt. Therefore, many investors still felt that the US was relatively a safe haven compared to other countries. Therefore, the dollar has maintained its value because it is still ‘relatively’ good. If the US had entered a recession on its own, the dollar would have fallen by much more.

4. Confidence.

If a country goes into recession, investors may lose confidence. For example, a recession will mean higher debt to GDP ratios and this may cause concern over reliability of bonds (especially in case of Euro). But, investors can also retain confidence in a currency, even if economy is in recession. It depends on prospects for balance of payments and underlying competitiveness.

Q10. Explain how Speculation is also one of the other factors.

A10. If a country's currency value is expected to rise, investors will demand more of that currency in order to make a profit in the near future. As a result, the value of the currency will rise due to the increase in demand. With this increase in currency value comes a rise in the exchange rate as well.

According to Economicshelp, an online source, a fixed exchange rate can be a victim of speculation if the following three conditions apply:

1. The currency is at the wrong market value
2. .The Government doesn’t have sufficient reserves to protect the currency.
3. People have no Confidence in the government intervention.

Q11. Write a note on factors affecting the exchange rate of indian rupee.

A11. As we know that Forex market for Indian currency is highly volatile where one cannot forecast exchange rate easily, there is a mechanism which works behind the determination of exchange rate. One of the most important factors, which affect exchange rate, is demand and supply of domestic and foreign currency. There are some other factors also, which are having major impact on the exchange rate determination. After studying research reports on relationship between Rupee and Dollar of last four years we identified some factors, which have been segregated under four heads. These are:

- Market Situations.
- Economic Factors.

- Political Factors.
- Special Factors.

1. Market Situations:

India follows the "floating rate system" for determining exchange rate. In this system "market situation" also is pivot for determining exchange rate. As we know that 90% of the Forex market is between the inter-bank transactions. So how the banks are taking the decision for settling out their different exposure in the domestic or foreign currency that is impacting the exchange rate. Apart from the banks, transactions of exporters and importers are having impact on this market. So in the day-to-day Forex market, on the basis of the bank and trader's transactions the demand and supply of the currencies increase or decrease and that is deciding the exchange rate. On the basis of this study we found out the different types of the decisions, which is affecting forex market. These are as follows:

- In India, there are big Public Sectors Units (PSUs) like ONGC, GAIL, IOC etc. All the foreign related transactions of these PSUs are settled through the State Bank of India. E.g. India is importing Petroleum from the other countries so payment is made through State Bank of India in the foreign currency. When State Bank of India (SBI) sells and buys the foreign currency then there will be noticeable movement in the value of rupee. If the SBI is going for purchasing the Dollar then Rupee will be depreciate against Dollar and vice versa.
- Importer and Exporter's trading is also affecting to the rupee. Like if an Indian exported material to U.S. so he will get his payments in Dollars and that will increase the supply of

Dollars and increase of demand of rupee and that will appreciate the rupee and vice versa.

- Banks can be confronted different positions like oversold or over bought position in the foreign currency. So bank will try to eradicate these positions by selling or purchasing the foreign currency. So this will increased or decrease demand and supply of the currency. And that will cause appreciation or depreciation in the currency.
- As we know that in India there is a floating rate system. In India Central Bank (RBI) intervenes in the forex market to ensure absence of volatility wherever necessary. RBI can achieve this by selling foreign exchange and buying domestic currency. Thus, demand for domestic currency which, coupled with supply of foreign exchange, will maintain the price foreign currency at the desired level. Interventions can be defined as buying or selling of foreign currency by the central bank of a country with a view to maintaining the price of a given currency against another currency. US Dollar is the currency of intervention in India.

2. Economic Factors:

In the Forex Market economic factors of the country play a pivot role. Every country is depending on its prospect economy. Here there are two types of economic factors. These are as follows:

- Internal Factors.
- External Factors.

Internal Factors includes:

- Fiscal Deficit of the country.
- Growth rate of the country.

- Foreign Exchange Reserves with the central bank
- Inflation Rate of the Country.
- Agricultural growth and production.
- Different types of policies like EXIM Policy, Credit Policy of the country as well reforms undertaken in the yearly Budget.
- Infrastructure development of the Country

External Factors includes:

- Export trade and Import trade with the foreign country.
- Loan sanctioned by World Bank and IMF
- Relationship with the foreign countries.
- Internationally price movements in commodities like gold and oil.
- Foreign Direct Investment, Foreign Portfolio Investment etc. in and out of the country.

3. Political Factors

In 1996, India was facing political instability and this type of political instability created hefty problem in the different market especially in Forex market, which is highly volatile. In fact in a particular succeeding year due to political uncertainty of ruling Government the rupee had depreciated by 30 paisa in the month of April. Due to political instability there can be possibility of delay in implementation of all policies and sanctioning of budget as well. So that will create a major impact on the trade of the country.

This shows how political factors can have an impact on foreign exchange.

4. Special Factors

Till now we have seen the general factors, which affects the Forex market in daily business. But sometimes some events happen in such a fashion that it will really change the whole scenario of the market; we call those factors, special factors. However traders have to really consider those things and take the decisions. We will see these types of factors in detailed:

In the year 1998, when Government of India did "Pokhran Nuclear Test", at that time rupee depreciated around 85 paise in day and 125 paise in seven days. Here the main fear was that U.S., Australia and other countries stopped sanctioning the loans, so this type of event will have major impact on the market. And due to this the decision procedure of the trader also varies.

Quoting another example, in the year 2000,India faced Kargil war, which is also had its impact on the market. By this war the defense expenditures were raised and due to that there was an increase in the fiscal deficit and it became an obstacle in the growth of the economy. So this type of event can also have an impact on the Forex market which do not fall under general category but could also occur uninformed.