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Factors Affecting Exchange Rates Part - 2

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1. Introduction

Foreign Exchange rate (ForEx rate) is one of the most important means through which a country’s relative level of economic health is determined. A country's foreign exchange rate provides a window to its economic stability, which is why it is constantly watched and analyzed. If you are thinking of sending or receiving money from overseas, you need to keep a keen eye on the currency exchange rates.The exchange rate is defined as "the rate at which one country's currency may be converted into another." It may fluctuate daily with the changing market forces of supply and demand of currencies from one country to another. For these reasons; when sending or receiving money internationally, it is important to understand what determines exchange rates.This session examines some of the leading factors that influence the variations and fluctuations in exchange rates and explains the reasons behind their volatility, helping you learn the best time to send money abroad.

2. 8 Key Factors that Affect Foreign Exchange Rates

1. Inflation Rates

Changes in market 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 positive influences 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.

2. Interest Rates

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

3. Country’s Current Account / Balance of Payments

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.

4. Government Debt

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.

5. Terms of Trade

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 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.

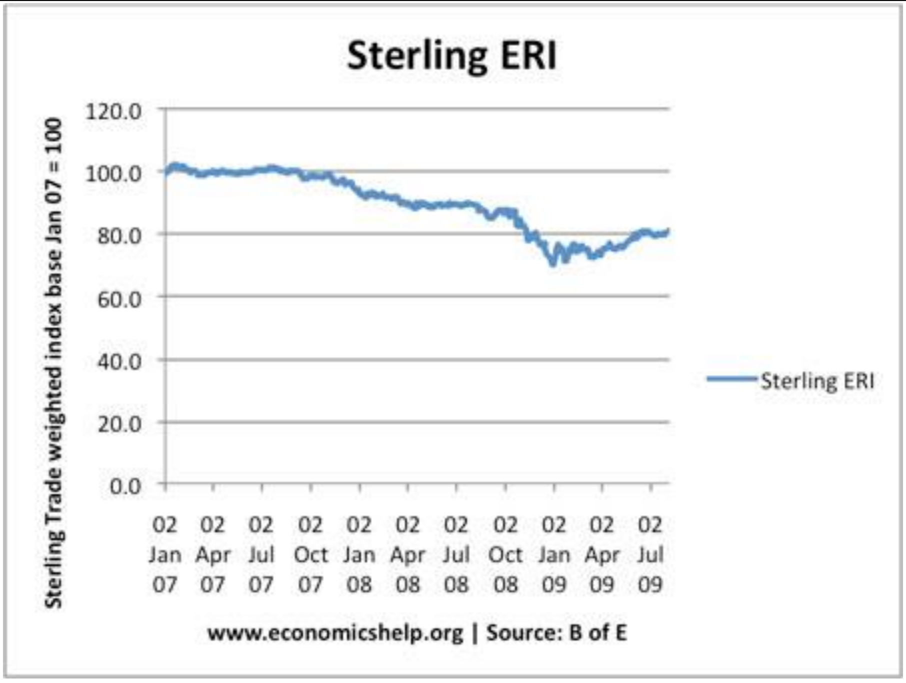
6. Political Stability & Performance

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.

7. Recession

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.)

Economic Theory behind the value of a currency in recession

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 have 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 (part of Q.E.) 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.

8. Speculation

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

- The currency is at the wrong market value
- The Government doesn't have sufficient reserves to protect the currency.
- People have no Confidence in the government intervention.

Summing up these factors affecting exchange rates:

All of these factors determine the foreign exchange rate fluctuations. If you send or receive money frequently, being up-to-date on these factors will help you better evaluate the optimal time for international money transfer. To avoid any potential falls in currency exchange rates, opt for a locked-in exchange rate service, which will guarantee that your currency is exchanged at the same rate despite any factors that influence an unfavorable fluctuation.

3. Factors Affecting the Exchange Rate of Indian Rupee

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 to 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 to 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 rupee. If the SBI is going for purchasing the Dollar then Rupee will be depreciated against Dollar and vice versa.

- Foreign Institutional Investor's (FIIs) inflow and outflow of the currency is having the major impact on the currency. E.g. U.S. based company is investing their money through the Stock markets BSE or NSE so her inflows of the Dollars is increasing and when it is selling out their investments through these Stock markets then outflows of the Dollars are increasing. However if the FIIs inflowing the capital in the country then there will be the supply of the foreign currency increases and Demand for the Rupee will increases and that will resulted appreciation in the rupee 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 be increased or decreased demand and supply of the currency. And that will cause to appreciation or depreciation in the currency.
- As we know that in India there is a floating rate system. In India Central Bank (RBI) is always intervene in the trade for smoothen the market. And this RBI can achieve 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 is playing the pivot role. Every country is depending on its prospect economy. If there will be change in any economy factors, which will directly or indirectly affected to Forex market. Here there are two types of economic factors. These are as follows:

- Internal Factors.
- External Factors.

Internal Factors includes:

- Industrial Deficit of the country.
- Fiscal Deficit of the country.
- GDP and GNP of the country.
- Foreign Exchange Reserves.
- 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 of the Country

External Factors includes:

- Export trade and Import trade with the foreign country.
- Loan sanction by World Bank and IMF
- Relationship with the foreign country.
- Internationally OIL Price and Gold Price.
- Foreign Direct Investment, Portfolio Investment by the country.

3. Political Factors:

In India election held every five years mean thereby one party has rule for the five years. But from the 1996 India was facing political instability and this type of political instability has created hefty problem in the different market especially in Forex market, which is highly volatile. In fact in the year 1999 due to political uncertainty in the BJP Government the rupee has depreciated by 30 paise in the month of April. So we can say that political can become important factor to determine foreign exchange in India.

Due to political instability there can be possibility of de possibility delaying implementation of all policies and sanction of budget. So that will create also major impact on trade.

4. Special Factors:

Till now we have seen the general factors, which will affect the Forex market in daily business. And on that factors the different players in the market have taken the decision. But some times some event happened in such a way that it will really change the whole scenario of the market so we can called that event 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 has done "Pokhran Nuclear Test" at that time rupee has been depreciated around 85 paise in day and 125 paise in seven days. Her main fear was that U.S., Australia and other countries have stop to sanctions 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.

In the year 2000,India has faced Kargil war, which is also affected to the market. By this war the defense expenditures are raised and due to that there will be increase in the fiscal deficit. And become obstacle in the growth of the economy. So this type of event has impact on the Forex market.

4. Summary

The exchange rate is the rate at which one country's currency may be converted into another. It may fluctuate daily with the changing market forces of supply and demand of currencies from one country to another. For these reasons; when sending or receiving money internationally, it is important to understand what determines exchange rates. The major factors affecting exchange rates worldwide includes 8 main points: Inflation rates, Interest rates, Public debt, Terms of trade, Balance of Payment, Speculations, Recession and Political stability & performance Factors affecting exchange rates in India which include: Market Situations, Economic Factors, Political Factors, Special Factors.