Exchange Rate

Meaning

- The exchange rates represent the value of one currency in relation to another.

- The rate at which one currency exchange with anothercurrency.

Type of exchange rate

- **Spot Exchange Rate:** This is the current exchange rate at which a currency pair can be bought or sold for immediate delivery. It's the rate you would typically see on currency converters and is used for immediate transactions.

- **Forward Exchange Rate:** This rate is a future exchange rate agreed upon today for a transaction that will take place at a specified date in the future. It allows parties to lock in an exchange rate for a future transaction to hedge against currency fluctuations.

- **The interbank exchange rate / Long exchange rate**: It refers to the rate at which banks and financial institutions trade currencies with one another. It's the wholesale rate used for large transactions between banks. This rate is not typically available to individuals or small businesses but serves as a benchmark for smaller financial entities and currency dealers.

- **Fixed Exchange Rate**: This is a system where a country's currency value is fixed, or pegged, to the value of another single currency or a basket of other currencies. The government or central bank often intervenes to maintain this fixed value.

- **Floating Exchange Rate:** Also known as a flexible exchange rate, this type is determined by the market forces of supply and demand. The currency's value fluctuates based on various factors such as economic conditions, geopolitical events, and market sentiment.

- **Cross Exchange Rate:** This rate involves the exchange rate between two currencies when neither is the domestic currency. It's calculated using the exchange rates of both currencies with a common third currency.

Determination of Exchange rate

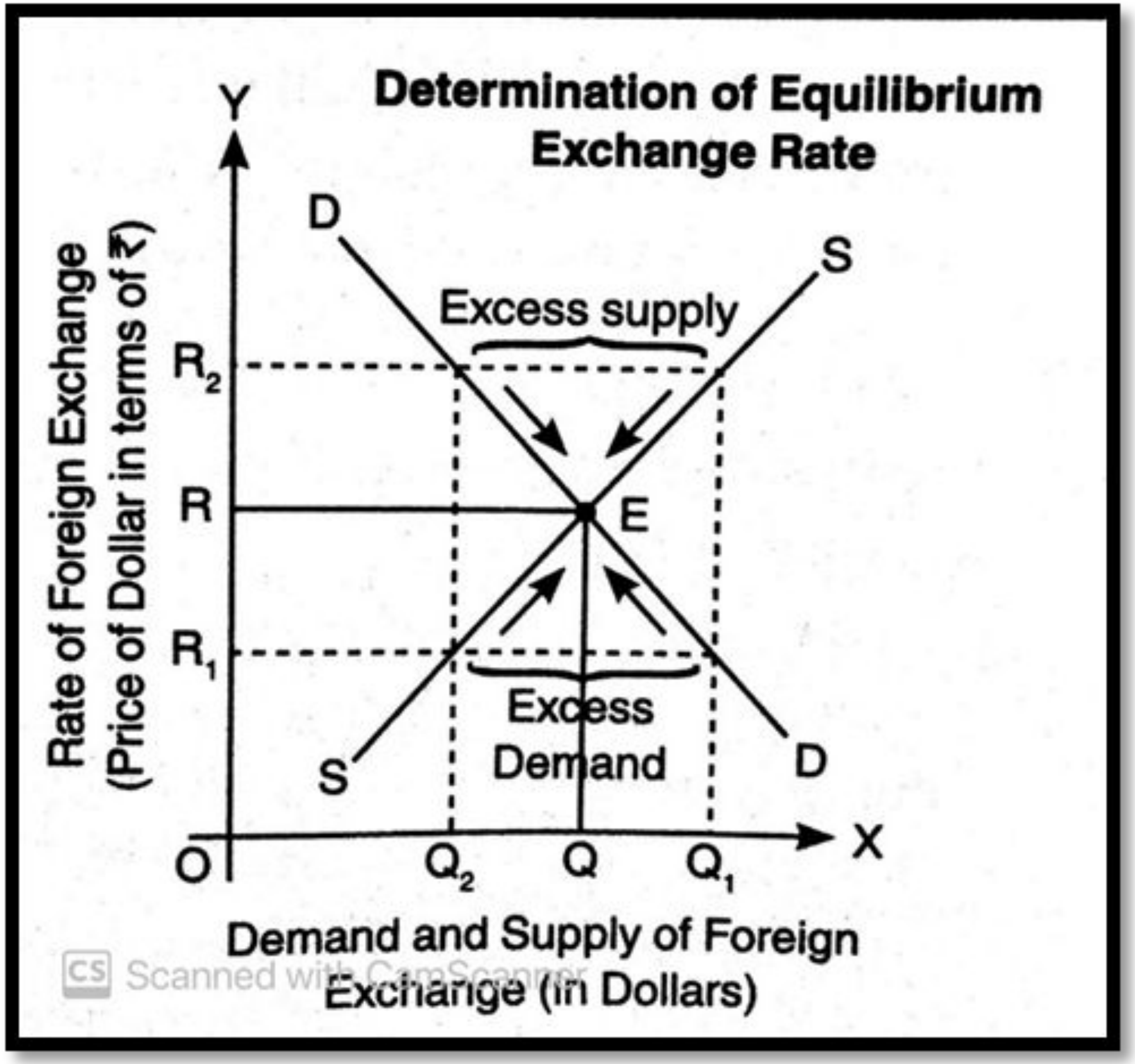
- Exchange rates are determined by a interaction of demand and supply .
- The exchange rate under free exchange market is determine at level where demand for foreign exchange is equal to the supply of foreign exchange.
- **Supply of Foreign Exchange:**
  - The supply of a currency in the foreign exchange market is determined by entities selling or providing that particular currency. (RBI in India)
  - In the context of international trade, the supply of a currency increases when a country's companies or individuals sell goods or services in exchange for foreign currency.
  - Foreign investors, tourists, or businesses converting their local currency into the host country's currency also contribute to the supply of foreign exchange.

- **Demand for Foreign Exchange**:

- Demand for a currency in the foreign exchange market is driven by entities seeking to purchase or obtain that currency.
- Importers looking to purchase goods or services from other countries require foreign currency to pay for those transactions.
- Foreign investors buying assets, such as stocks, bonds, or real estate in a particular country, need that country's currency, increasing demand for it.
- Tourists exchanging their local currency for the currency of the country they're visiting create demand for foreign exchange.

The equilibrium of supply and demand sets the exchange rate. When the demand for a currency exceeds its supply, its value typically rises against other currencies. Conversely, if supply surpasses demand, the currency's value tends to decrease.

Determination of Equilibrium Exchange rate:



Theories of Exchange rates

- The theory of exchange rates encompasses various economic principles and models that aim to explain how exchange rates are determined.

1. **Mint Parity Theory**: During the era of the gold standard, countries often fixed the value of their currencies in terms of a set amount of gold. The mint parity refers to the official or fixed exchange rate between a country's currency and a specified amount of gold.

2. **Purchasing Power Parity (PPP) Theory:** This theory suggests that in the absence of transaction costs and barriers, the exchange rate between two currencies should equalize the prices of a basket of goods and services in each country.

3. **Balance of Payments (BOP):** A surplus or deficit in the balance of payments can impact a country's exchange rate by influencing demand for its currency.

- **Interest Rate Parity (IRP):** IRP theory states that the difference in interest rates between two countries should equal the difference between their exchange rates in order to prevent arbitrage opportunities.

- **Asset Market Model:** This model suggests that exchange rates are determined by the supply and demand for financial assets.