EXCHANGE RATE

Foreign Exchange Rate is defined as the price of the domestic currency with respect to another currency. The purpose of foreign exchange is to compare one currency with another for showing their relative values.

Foreign exchange rate can also be said to be the rate at which one currency is exchanged with another or it can be said as the price of one currency that is stated in terms of another currency.

Exchange rates of a currency can be either fixed or floating. Fixed exchange rate is determined by the central bank of the country while the floating rate is determined by the dynamics of market demand and supply.

Factors Affecting the Exchange Rate

Exchange rate is impacted by some factors which can be economic, political or psychological as well. The economic factors that are known to cause variation in foreign exchange rates are inflation, trade balances, government policies.

Political factors that can cause a change in the foreign exchange rate are political unrest or instability in the country and any kind of political conflict.

Psychological factors that impact the forex rate is the psychology of the participants involved in foreign exchange.

Types of Exchange Rate Systems

There are three types of exchange rate systems that are in effect in the foreign exchange market and these are as follows:

1. Fixed exchange rate System or Pegged exchange rate system: The pegged exchange rate or the fixed exchange rate system is referred to as the system where the weaker currency of the two currencies in question is pegged or tied to the stronger currency.

Fixed exchange rate is determined by the government of the country or central bank and is not dependent on market forces.

To maintain the stability in the currency rate, there is purchasing of foreign exchange by the central bank or government when the rate of foreign currency increases and selling foreign currency when the rates fall.

This process is known as pegging and that's why the fixed exchange rate system is also referred to as the pegged exchange rate system.

Advantages of Fixed Exchange Rate System

Following are some of the advantages of fixed exchange rate system

1. It ensures stability in foreign exchange that encourages foreign trade.
2. There is a stability in the value of currency which protects it from market fluctuations.
3. It promotes foreign investment for the country.

4. It helps in maintaining stable inflation rates in an economy.

Disadvantages of Fixed Exchange Rate System

Following are some of the disadvantages of the fixed exchange rate system

1. There is a constant need for maintaining foreign reserves in order to stabilise the economy.

2. The government may lack the flexibility that is required to bounce back in case an economic shock engulfs the economy.

2. Flexible Exchange Rate System: Flexible exchange rate system is also known as the floating exchange rate system as it is dependent on the market forces of supply and demand.There is no intervention of the central banks or the government in the floating exchange rate system.

Advantages of Floating Exchange Rate System

Following are the advantages of the floating exchange rate system

1. There is no need to maintain foreign reserves in this exchange system.

2. Any deficiencies or surplus in Balance of Payment is automatically corrected in this system.

Disadvantages of Floating Exchange Rate System

Following are some of the disadvantages of the floating exchange rate system

1. It encourages speculation that may lead to fluctuations in the exchange rate of currencies in the market.

2. If the fluctuations in exchange rates are too much it can cause issues with movement of capital between countries and also impact foreign trade.

3. It will discourage any type of international trade and foreign investment.

3. Managed floating exchange rate system: Managed floating exchange rate system is the combination of the fixed (managed) and floating exchange rate systems. Under this system the central banks intervene or participate in the purchase or selling of the foreign currencies.

What Is Purchasing Power Parity?

Purchasing power parity (PPP) is a popular macroeconomic analysis metric used to compare economic productivity and standards of living between countries.

PPP involves an economic theory that compares different countries' currencies through a "basket of goods" approach. That is, PPP is the exchange rate at which one nation's currency would be converted into another to purchase the same and same amounts of a large group of products.

According to this concept, two currencies are in equilibrium—their currencies are at par —when a basket of goods is priced the same in both countries, taking into account the exchange rates.

How PPP Is Used

To make a meaningful comparison of prices across countries, a wide range of goods and services must be considered. However, the one-to-one comparison is difficult to achieve due to the sheer amount of data that must be collected and the complexity of the comparisons that must be drawn.

To help facilitate this comparison, the University of Pennsylvania and the United Nations joined forces to establish the International Comparison Program (ICP) in 1968.

Users of PPP

With this program, the PPPs generated by the ICP have a basis in a worldwide price survey that compares the prices of hundreds of various goods and services. Thus, the program helps international macroeconomists estimate global productivity and growth.