# Foreign Exchange Markets and Exchange Rates

The foreign exchange transaction involves the payment and the receipt of the foreign exchange within two business days after the day the transaction agreed upon. This called spot transaction and the rate is called spot rate.

Forward transaction involves an agreement today to buy or a sell a specified amount of foreign currency at specified future date at a rate agreed upon today is called forward transaction and the rate is called forward rate.

Forward premium / Forward discount

**Currency swaps**

- It refers to a spot sale of a currency combined with a forward repurchase of the same currency- as part of a single transaction.
- The difference between the spot rates and forward rates is called swap rates.

# Futures and Options

- A foreign exchange futures is a forward contract for standardized currency amounts and selected calendar dates traded on an organized market(exchange). The currencies traded are the Japanese yen, the Canadian dollar, the British pound, the Swiss franc, the Australian dollar, the Mexican Peso and the euro. Only four dates per year are available: the third Wednesday in March, June, September and December.

- In futures market only few currencies are traded only standardised contracts and only specified delivery dates and are subject to daily limits on exchange rate fluctuations.

**Options:**

- It is a contract giving the purchaser a right , but not the obligation, to buy (a call option) or sell (a put option) a standard amount of a traded currency on a stated date (the European option) or any time before a stated date (An American option)at a stated price (the strike price or exercise price)

- Euro Bonds and Euro notes

# EXCHANGE RATE REGIME

## THE GOLD STANDARD PERIOD (1880-1914)

- This period was from 1880 to 1914. Under this system each nation defined the gold content of its currency and passively stood ready to buy or sell any amount of gold at that price. The exchange rate was determined within the gold points by the forces of demand and supply and was prevented from moving outside the gold points by gold shipments.
- The adjustment mechanism under the gold standard, as explained by **Hume, was the automatic price-specie-flow** mechanism, which operated as follows.

Since each nation's money supply consisted either in gold or paper currency backed by gold, money supply would fall with the increase in deficit which would bring down the prices in the deficit country and increase the price levels in the surplus country (quantity theory of money).

For example if prices of the commodities in Nation 1 are more than nation 2 , the imports of nation 1 will increase, which will bring down the gold reserves (money supply) thereby the prices in the nation 1 will decrease and with nation 2 as exports increase gold reserves (money supply) increases thereby the prices in nation 2 will rise.

Based on the quantity theory of money as the deficit in nation 1 lost gold, its money supply would fall and cause internal prices to fall proportionately. For example, a deficit in nation 1's balance of payments and gold loss that reduced by 10 percent would also reduce prices by 10 percent.

- This again boosts the exports in the deficit country and imports in the surplus country which will bring parity between the nations and disequilibrium in balance of payments is corrected.
- Governments effectively suspended the gold standard during the World War I and financed part of their massive military expenditures by printing money.

**Marshall- Lerner Conditions**

•Devaluation makes the imports of the devaluing costlier than before and in case her demand for imports is inelastic, a higher amount will be spent for the same imports, thereby worsening her balance of trade.

• Similarly, if her export demand is inelastic, then, after devaluation, lesser amount will be spent by the foreigners thereby affecting adversely balance of payments of the devaluing country.

- However, if her demand for exports is elastic then with the fall in the prices of the exports as a result of devaluation, more will be purchased by the foreigners, which in turn will help in resorting the equilibrium in her balance of payments.
- Likewise, if her demand for imports is elastic, then the imports of the country will be significantly reduced by devaluation, which in turn would improve the balance of payments of the devaluing country.

•However, some rule is needed to relate the required degrees of elasticities for the success of devaluation in improving the balance of trade.

•According to **Marshall-Lerner** conditions, devaluation improves the balance of trade of a country if the sum of elasticities of demand for imports and exports is greater than one.

•When sum of these elasticities is equal to one, devaluation will leave the size of the deficit unchanged; and when this is less than one, it will make the balance of payments worse than before.

- Marshall-Lerner conditions relate only to demand for the commodity exports and imports. The response of capital, both official and private, to devaluation must also be taken into consideration before it can be determined whether devaluation will improve the balance of payments.
- (this is because of the fact that both the current and capital account constitute the balance of payments of a country).

- J-curve
- Interest rate differentials interest rate parity theory