so that OR quantity of foreign exchange supply is equal to same quantity of demand for foreign exchange. Foreign exchange rate at this equilibrium point is OF. At this point balance of payments is said to be in equilibrium. No other point other than point F can be considered an equilibrium foreign exchange rate. If the rate is higher than F, then the supply of foreign exchange exceeds demand for it; which would result in a fall in foreign exchange rate until it is F. Similarly, any rate lower than F means there is excess of foreign exchange demand over its supply which would lead to an increase in foreign exchange rate until it reaches F level. It is to note that this is the only natural rate that should prevail in the market, but there are always fluctuations in the foreign exchange rate on day-to-basis, which may cause a change in the existing foreign exchange rate.

Spot and Forward Foreign Exchange Transaction

Spot foreign exchange transaction refers to the purchase or sale of foreign exchange for immediate delivery. The exchange rate at which the transaction takes place is called the spot rate. For example, if Rs. 1000 could be obtained immediately by paying $ 25, then spot exchange rate is $ 1 = Rs. 40.

Forward foreign exchange transaction refers to agreement made today to buy or sell a specified amount of foreign exchange at a specified future date at the rate which is agreed upon today. For example, a person has entered into an agreement today to purchase $ 100 three months later at agreed rate, say, $ 1= Rs. 40. Then after three months, the person will make payment of Rs. 4000 to purchase $ 100 at that agreed upon rate, not considering of what the spot rate is at the time of transaction. If after three months the spot rate is $ 1 = Rs. 50, then the person makes a profit of Rs. 1000. If, on the other hand, spot rate is $1 = Rs. 20, then there is a loss of Rs. 2000 for the person. Forward exchange rate contracts are generally made for a period not exceeding six months. While spot rate is determined by market demand curve and market supply curve of foreign exchange for immediate delivery, forward exchange rate is determined by the demand for and supply of foreign exchange for future delivery.

EXCHANGE RATE SYSTEMS

In this section we will take a look at the different exchange rate systems which have been practiced from time to time. A broad classification of the system is as follows:

1. Floating Exchange Rates
2. Pegged or rigidly fixed exchange rates
3. Managed Flexibility.

Floating Exchange Rates

Under this system, there is no intervention by the government or central bank of a country in foreign exchange rate market. Thus an independent economic policy can be pursued under flexible exchange rate. Its monetary policy is not rigid to a certain rate of exchange. The rate of exchange has an equilibrating influence on the balance of payments and it is better to let this equilibrating factor work freely and automatically. Floating rates checks inflationary and deflationary forces to penetrate in the economy. Fluctuating exchange rates of exchange do not discourage long-term investments as it is supposed.

Ref – Intro to Economics, By *Dutta*, New Age Pub

Pegged or Rigidly Fixed Exchange Rates

Under this system, there is complete government interference in the foreign exchange market. The exchange rate is fixed at a given equilibrium level and if there is any upset in the equilibrium, the government would intervene and take attempts to establish equilibrium. The government does this by selling or buying foreign exchange i.e., by pegging or supporting the equilibrium exchange rate. The government is able to do so by maintaining a buffer-stock of foreign exchange. This means, buying foreign exchange when there is too much supply and selling the same when there is too much demand for it. Thus, the purpose of the system is to stabilize the price of foreign exchange at a given equilibrium rate.

Such a system stabilizes exchange rates and thereby creates a congenial atmosphere in which operations relating to international trade function smoothly and in an orderly manner. Moreover, it controls and prevents speculative activities in regard to foreign exchange. It also checks currency appreciation or depreciation and provides strength to the domestic currency.

But there are disadvantages too of this method. It creates a heavy burden on the government. A large foreign exchange reserves has to build, which is another problem for the government. Moreover, the process actually does not solve the balance of payments problem, but only suppresses it through government intervention. Again, it requires a greater need for creating international institutional arrangements for borrowing and lending international liquidity as accommodating balance of payments transactions.

Managed Flexibility

Under this system, we have the following categories:

1. Adjustable peg system
2. Crawling or trotting or gliding parity
3. System of clean float and dirty float.

Adjustable peg system: Under the system of adjustable peg, a country should try to have a system of fixed exchange rates for as long as it can, i.e., until the country exhausts all its foreign exchange reserves. Till then, the country should peg or support its fixed exchange rate. Once the foreign reserves are exhausted, the country should undertake devaluation and move to another equilibrium exchange rate. In other words, the system involves pegging the exchange rate to a given level at a given time and as situations change, the old peg is discarded when it is no longer feasible and process continues adjusting to a new peg. The adjustable peg system is also described as maximum devaluation system, because after a wait for a relatively long time, a sudden big devaluation of currency is done.

Crawling or trotting or gliding parity: We have seen that there is sudden devaluation of currency in the above system, which in fact is harmful for an economy and therefore it is need to avoid. Crawling peg systems advocates adjusting of exchange rate to a new demand and supply conditions continuously and regulate the exchange rate at frequent intervals. Thus, in this system we keep on moving from one peg to another rather rapidly, without waiting until all our foreign reserves are finished at any one given rate of exchange.

The adjustable peg system is closer to fixed exchange rate policy, whereas the crawling peg system is closer to flexible exchange rate policy.

System of clean float and dirty float: In case of clean float, the exchange rate is allowed to be determined by free market forces of demand and supply of foreign exchange. There is no government intervention in the foreign exchange market. Thus it is identical to freely fluctuating exchange rate policy.

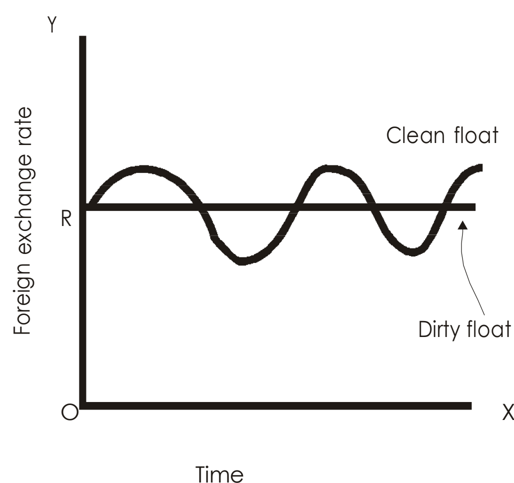

Fig. 26.2

Dirty float means that we allow the exchange rate to be determined by the market forces of demand and supply of foreign exchange but government intervention in the market is also allowed in order to iron out the ups and downs in the exchange rate movement. Clean float system ensures exchange rate stability with a certain degree of exchange rate flexibility but dirty float system sticks to exchange rate stability allowing no exchange rate fluctuation. The Fig. 26.2 shows the two cases.

BAND SYSTEM

The Bretton Woods system of exchange rates, which was in vogue from 1944 till 1971, was one of relatively fixed exchange rates. System of fixed exchange rates has some degree of flexibility within a limited band or range of exchange rates fluctuations. This system of fixed exchange rates is the band system or the Bretton Woods system. The range between the two rates of exchange is called the band within which the exchange rate is allowed to fluctuate. The upper or lower limits of the band are set by the government or suggested by the IMF to member countries. The government allows free market forces to influence exchange rate on condition that the exchange rate fluctuates within the band as set by the government. The size of the band is determined by the extent of fluctuations, which the authorities consider desirable or practicable. Initially the IMF permitted fluctuations in exchange rate of member countries within 1% of the band on either side. Later, it was raised to 2.25% on either side of the fixed parity. It should be noted that the exchange rate is not allowed to go outside the limits of the band.

Questions for Review

1. What do you mean by foreign exchange rate?
2. Define foreign exchange market.
3. What are spot and forward markets in foreign exchange? Give suitable illustrations.
4. Explain the meanings of crawling peg and managed float.
5. How is foreign exchange rate determined in a free foreign exchange market?
6. Why do we demand foreign exchange?
7. Explain supply of foreign exchange.
8. What do you mean by dirty float?
9. If a machine costs Rs. 1000 in India and $ 50 in U.S.A, then what will the exchange rate between India and U.S.A?

BALANCE OF PAYMENTS ACCOUNT—MEANING AND COMPONENTS

The balance of payment is one of the most important statistical statements for any country. It is a systematic record of all economic transactions between the residents of a country and of the residents of the rest of the world in an accounting year. One should keep in mind that the word 'payments' does not mean items which only involves payments of a country, but it includes both payments and receipts of a country. Similarly, the word 'balance' does not mean state of equilibrium or favourable situation, but it only means that it is a balance sheet of receipts and payments having an accounting balance.

Thus, it is clear that balance of payments transactions include all the foreign receipts of and payments by a country during a given year. Receipts are the earnings and borrowings of foreign exchange, which are recorded as credit items in the balance of payments accounts. Payments, on the other hand, refer to all spending and lending of foreign exchange by a country and these are recorded as debit items. We thus see that all receipts of a country are financial inflows and all payments are financial outflows in a year. We must always remember that in pure accounting terms or book-keeping sense, the balance of payments must always be in balance, because the balance of payments is a schedule showing debit and credit transactions which must be equal. This equality does not mean that the balance of payments is in equilibrium or favourable situation. There may be disequilibrium-deficits and surplus, in the balance of payments. The balance of payments statements generally contain the following major accounts:

1. Goods Account.
2. Services Account.
3. Unilateral Transfers Account.
4. Long-Term Capital Account.
5. Short-Term Capital Account.
6. International Liquidity Account.

Let us explain these briefly as below:

Goods Account

This account contains record of the value of merchandise exports and the value of merchandise

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imports. These items of earnings and spending are called 'visible items' in the balance of payments. If the receipts from exports of goods are equal to the payments for the imports of goods, we call the situation as zero 'goods balance'. If receipts exceed payments, it is called positive goods balance and in case it is short of payments, it is negative goods balance. A positive goods balance is considered favourable for a country while that of negative is treated as unfavorable.

Services Account

This account records the value of exports and imports of intangible goods or services. These are regarded as 'invisible items' in the balance of payments. These are invisible in the sense that service receipts and payments are not recorded at the port of entry or exit as is the case with the merchandise imports and exports. Transactions relating to services generally include – transportation, banking and insurance, tourism, travel services, purchase and payments of goods and services by tourists, expenses of students studying abroad, diplomatic and military expenses, interest, profits, dividends, and royalties receipt and payments. These items are generally termed as investment income or expenditure or receipts and payments arising out of what are called as 'capital services'. When we add up all items in the services account, which may be positive or negative or zero, it is said as 'service balance'. A positive sum is regarded as favourable to a country.

Unilateral Transfers Account

This account records the value of gifts, grants and reparation receipts and payments to foreign countries. It consists of two transfers — government transfers and private transfers. Foreign aid or military aid received by a country from a foreign country in times of crises or during war is government to government transfers. Private transfers are funds received from or remitted to foreign countries on person-to-person basis. An Indian working as software engineer in Microsoft Company in U.S.A remits money to his parents staying in India is an example of private transfers.

Long-Term Capital Account

This account includes the amount of capital that has moved into or out of the country in a year. Any amount of capital that has moved in or out of the country for a period of one year or more is regarded as long-term capital movement. This account consists of private direct investment, private portfolio investment and government loans to foreign countries. Private direct investments are investments made by residents and firms of a country in foreign countries and by foreigners in the home country. Private portfolio investments are the investments done by residents and firms of a country in foreign securities and by foreigners in home country securities. Government loans to foreign governments include loans given by home country to foreign country and from foreign country to home country.

Short-Term Capital Account

The short-term capital account includes bank deposits and other short term payments and credit arrangements. These are receipts and payments effected in less than a year. Most of the short-term capital transactions represent bank transfers that finance trade and commerce.