1International Business
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Lecture – 31
Factors affecting Exchange Rate, Current Account Deficits, Government Debt, Exchange Rate Systems

Welcome, friends to our class of International Business. So, in the last lecture, we had started with one of the very important chapter, topic which is called the Foreign Exchange. So, I hope you must have all heard hundreds of times what foreign exchange is all about and in simple terms as we started we understood that is foreign exchange is nothing, but the exchange of one currency against another, right.

So, let us say and at what value it transacts. For example, today the Indian rupees is stands at let us say you know 71 rupees is equal to 1 dollar. So, that is what is the foreign exchange right. So, and what does it matter and why does it matter? Because it simply helps us in the transaction, doing a transaction.

So, when India or any country for that it wants to do business across the globe so then it needs different kinds of currencies right. Suppose, it wants to transact with UK, Britain so, we need pound sterling; we want to go to Mexico, we want peso; we want to go to US, we want the dollar. This is all for different countries there are different currencies and to do business with them we need different all the host currencies right.

But, there are some vehicle or major currencies also which are acceptable in most of the countries one like for example, being the dollar right. So, the dollar is called a vehicle currency and this is acceptable in almost all the countries, ok. So, how do you determined how does what factors affect the exchange rate; that means, the rate at which the rupee is you know valued right or the dollar is valued. So, that is called the exchange rate ok.

So, in the last lecture we discussed about the factors affecting the exchange rate right. So, if rupee is today 71, why it is 71? The question right and what happens if so rupee it become 73 or rupee become 69? How does it affect our business? We all understand that it surely affects, there is no doubt about it because after all we are paying the you know the amount on basis of this valuation right. So, if it becomes 71 instead of 73 instead of 71 which is there today then we are paying 2 rupees more right for each unit.

And, similarly if it goes down and become 69 then we are paying 2 rupees less, but on the other hand similarly, if we are let us say doing export so, somebody if it increases what happens, if it decreases what happens that also we discussed. Suppose, the rupee strengthens against the dollar right now that means, what? The exporters the people who are buying our products right they will be able to buy now less amount of the goods because our rupee has strengthened right.

So, the they can buy less amount of the substance with the same amount of dollars. So, that is why for exporters the appreciation of the rupee does not help much, but on the other hand when you are importing and you are paying at that time if the rupee is appreciating it is a good thing right. So, this is very important and this basic fundamental is to be understood by everybody.

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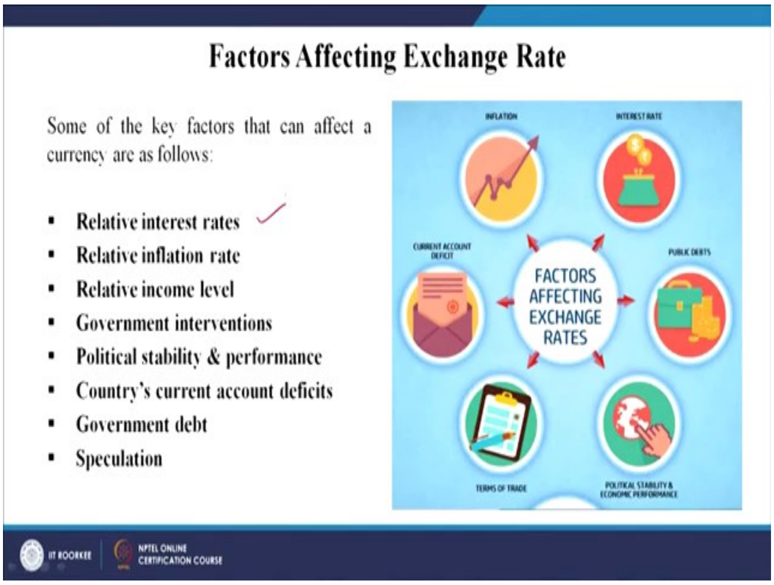

So, what factors affect we said? One is the relative interest rate. So, if the interest rate in a country is changing, accordingly the country becomes a very attractive destination for investments right. So, that decides how what is your interest rate. Then what is the inflation rate? Inflation rate means the cost of the goods we discussed and if the inflation rate is high, it does not have a positive impact.

What happens when there is a high income level? High income level leads to high consumption right high consumption means; high you know production right. So, there is a chain there is a circular affect right.

The government also intervenes in between sometimes whenever the government feels that you know the we need to save our domestic players or we need to boost up our exports. So, the government intervenes and changes maybe the interest rate and the monetary policies are adjusted accordingly.

Similarly, political stability and performance and for example, you see the exchange rate for one country is also largely affected by how much of political stability is there in that country. If the country is going through a instability then the exchange rate the countries you know the currency would be become weak.

So, political stability is also and also foreign investors the foreign players who want to invest in your country so, if they want to invest they would look at how much stability is there in the country right. Another point that we will talk about today we start from here is the country's current account deficits, right.

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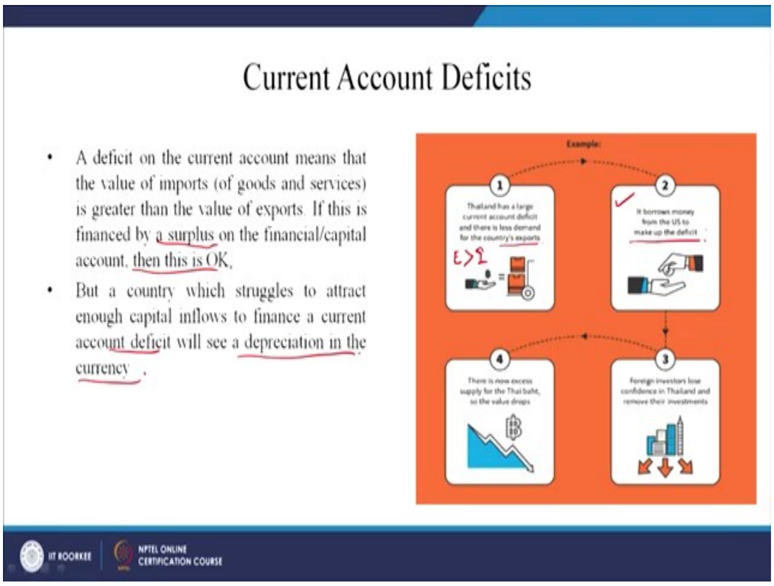

So, let us start from here. A deficit on the current account we now we have understood there are two kinds of basically accounts one is the current account and the capital account right. So, the current account now what it says when there is a deficit in the current account so, it could be a deficit or a surplus right.

If your exports are high, then you can be on a surplus if you are imports are more then you can be on a deficit. So, the deficit on the current account means that the value of imports is greater than the value of exports. If this is financed by a surplus on the financial or the capital account, then this is ok.

Now, what it is saying? Now, if the current account deficit is you know is positive; that means, there is a surplus right if it is financed by a surplus; that means, it is there is a surplus then it is a good condition right, but a country which struggles to attract enough capital inflows right to finance a current account deficit we will see a depreciation in the currency.

Now, now as you can see let us take this example. Now, this country Thailand has a large current account deficit right. This is an example and when there is a current account deficit we have understood that the exports are less much less than the import. So, the ability to earn dollars is less right. So, when there is a current account deficit and there is less demand for the country's exports. So, the exports are going down.

In such a situation what will happen? In order to adjust it is current account deficit Thailand would borrow money from the US or somebody some other player to make up this deficit right or the IMF if it is a member whatever right. So, now, to make up this deficit they have borrowed money, suppose the investors lose confidence due to several reasons could be political could be any reason. So, lose confidence in Thailand and remove their investments what happens?

There is now excess of supply for the Thai baht which is and the value of the currency of the Thailand drops. So, this is a situation which is the difficult situation for a country suppose that it is going through a current account deficit and if they are depending on the external fund and somehow the foreign investors do not have the confidence and they pull back their money in that case there is large supply and then when there is a large supply automatically you can understand that the value of the currency would tend to depreciate right.

It would become a weak currency it would lead to a rise in inflation right because there is an excess currency and the value of a currency is now coming down.

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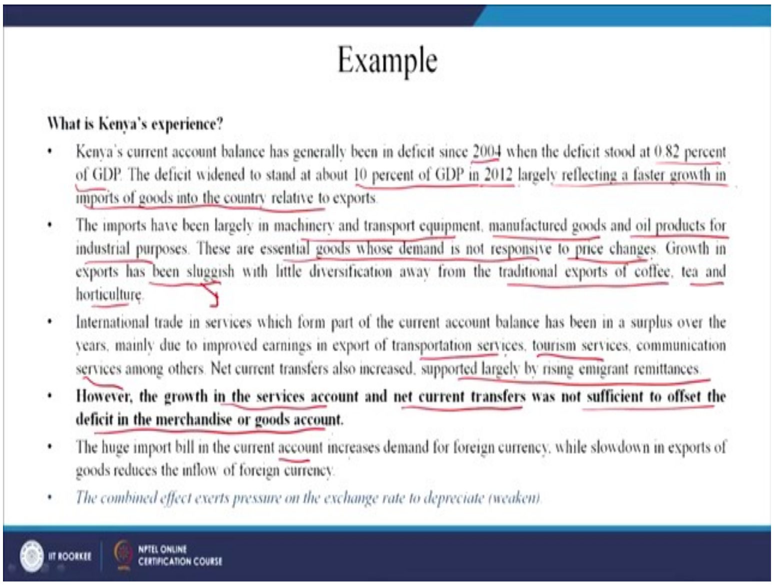

Let us take this example Kenya's current account balance has generally been deficit since 2004 when the deficit stood at 0.82 percent of the GDP. The deficit widened to stand at about 10 percent of GDP in 2012. So, 2004 it was 0.82 which moved on and rose to 10 percent of the GDP by 2012 largely reflecting a faster growth in imports of goods into the country related to the exports.

So, the country Kenya was importing more right, it is not bad to import because when you import you also start producing goods. But, when this difference between exports and imports becomes very high severe and it is not reflected through the exports then it is a point of concern.

The imports have been largely in machinery and transport equipment, manufactured goods and oil products for industrial purposes. These are essential goods whose demand is not responsive to price changes there is the elasticity is very poor; that means, they would not respond to price changes. Growth in exports has been sluggish; this is difficult now.

With if these things would after the import of the such these goods had the exports would have reason then there would not have been much of a problem, but exports also did not grow. Why export did not grow, there could be several reasons for it right with little diversification away from the traditional exports of coffee, tea and horticulture.

International trade in services which form part of the current account balance services also depart goods and services has been in a surplus over the years, right mainly due to improved earning in export of transportation services, tourism, communication etcetera. Net current transfers also increased, supported largely by rising emigrant remittances right.

However, the growth in the services account and net current transfers was not sufficient to offset that deficit in the merchandise or the goods account right. So, whatever improvement happened in the services account that was not good enough to cover you know cover up the you know deficit in the merchandise or the goods account.

The huge import bill in the current account increases demand for foreign currency. Obviously, when you want to buy something you want the foreign currency, while slowdown in exports of goods reduces the inflow of the foreign currency. The combined effect exerts pressure on the exchange rate to depreciate. So, this is what happened with Kenya right and it is not recovered from it fully till now. Many countries are going through this you know phase.

In fact, I am not very happy to say that at the current moment, India's condition also has been slightly on the negative right; that means, our you know deficits are increasing, our imports exports have come down to a very low level right and this is not a very good sign right.

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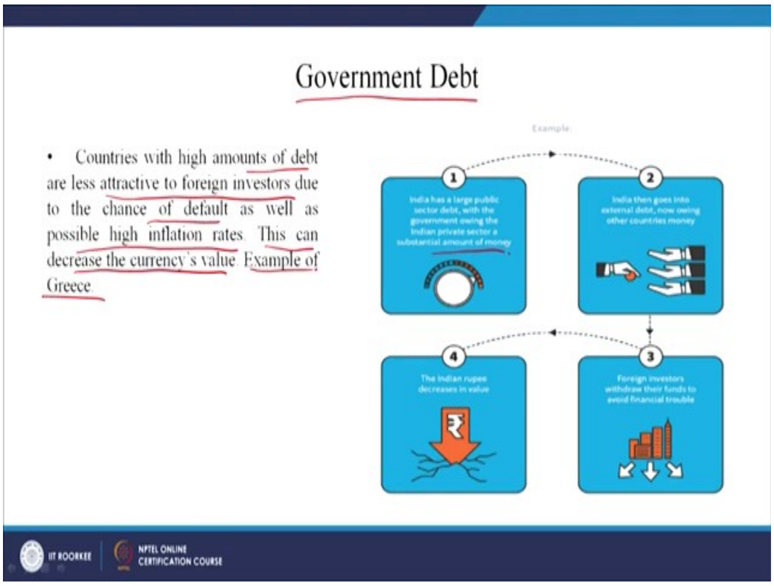

The another point that affects the foreign exchange is the government debt. How much debt; how much debt in the government is having? Now, some countries have largely been dependent on debt for example, Greece you know I think I have given this example also for.

Let us see countries with high amounts of debt are less attractive to foreign investors due to the chance of default as well as possible high inflation rates. So through debt when you have got the money so, it is possible that you may not be able to pay back right. So, when you default that is a dangerous sign. This can decrease the currency's value. Example of Greece.

Let us look at this case India has a large public sector debt right with the government owing the Indian private sector a substantial amount of money right. Today, if you look at India's NBFC problem if you look at the banks issues, you will understand what is the problem of debt and how it had a seriously adverse effect on the Indian economy right.

India then goes into external debt now because they require money India goes for an external debt now owing other countries money. So, we have taken loan from other places. Foreign investors withdraw their funds to avoid financial trouble. So, for example, when there is an instability there is a risk of or some you know kind of a instability in the country due to maybe civil problem or any problem so, the foreign investors withdraw their funds.

The Indian rupee decreases in value. So, this has happened in the recent past in the last few years the Indian rupee has decreased in value right. So, this is also an example connected with India right and it has become more of a problem in the recent time at least 2019 it has become a serious issue.

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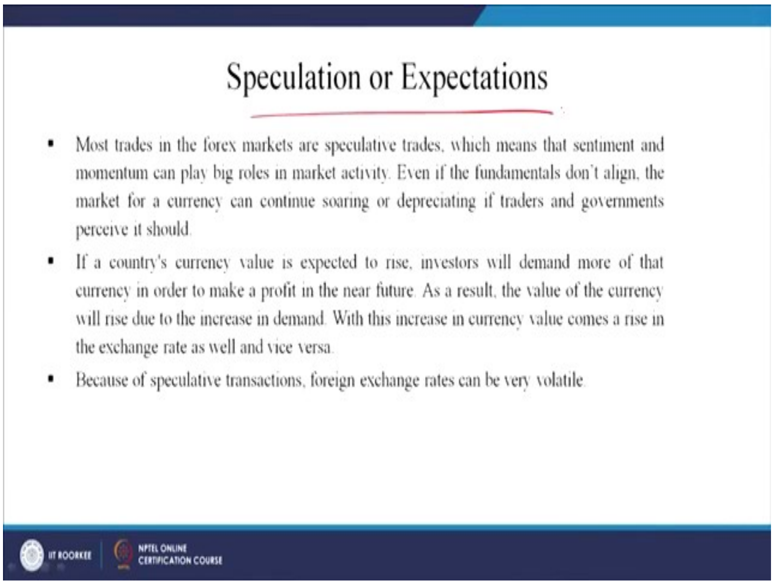

Then speculation or expectations most trades in the forex market the foreign exchange market are speculative trades. Now, what are speculation? Now, Ben Graham, Benjamin Graham says, speculation means when person trades for greed when he does not own something and he wants to still transact make transactions on that right.

So, which means now when you are making a speculation for; that means, for greed you do not own maybe you are feeling the market will go up so, you tend to buy or you feel the market will go down so, you tend to sell without even owning the stock or the product. So, in such a condition when the markets are going for a speculative most trades in the forex markets you say it says a are a speculative trade which means that sentiment and momentum can play big roles in market activity.

Even if the fundamentals do not align the market for a currency can continue soaring or depreciating if traders and government pursued it should. Now, let me explain this. Speculation means I speculate I feel earlier the Indian stock exchange in the Indian stock exchanges also there used to be a role of speculation right. So, that means, what suppose you do not have a share let us say you feel the market will go down let us say a reliance will go down let us say understand.

So, what you in the anticipation of that you have sold 100 reliance right and on the contrary what happened had it gone down suppose it went down by 20 rupees you are holding 100 stocks. So, what happens 100 * 20= 2000 rupees you gain, but on the contrary suppose it goes up now what happens you are going to lose 20 rupees now from 100 to 120 it has becomes.

So, the 20 rupees instead of falling it has gone up. So, this 20 * 100 stocks is a loss of thousand to a you know 2000 rupees to you. So, now this is a speculation. This happens because of a greed or a fear in the market right. The forex market largely depends on this ok.

If a country's currency value is expected to rise for example, somebody feels people feel that India is doing is having a good government and things would grow, investors will demand more of that currency in order to make a profit in the near future right. 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 and vice versa right. So, when this grows the exchange rate also moves.

Because of speculative transactions foreign exchange rates can be very very volatile. So, sometimes for example, Indian stock exchange the SEBI at the government restricted the speculative trades and stopped because many people lost you know the retail investors lost a huge amount of moneys on this speculation right. So, they were asked to hold it either they you can only transact when you hold the stock, if you do not hold it you cannot make any transactions.

So, this was something which is could be done here, but in the forex market this does not happen right.

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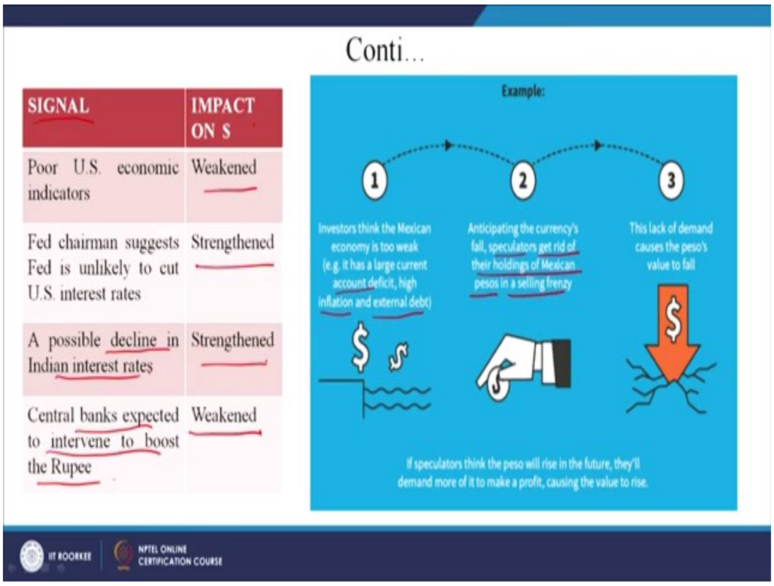

Now, let us take another example. Let us say this one, let us take this. How what is the role of the signals right and the impact on the dollar. Suppose poor US economic indicators right now suppose let us say there is an election coming up and people are in doubt whether Trump would win or not. So, that has a weakened that weakens the dollar right.

Fed chairman there is some examples suggest fed is unlikely to cut US interest rates. So, if the interest rates are you know are will remain as it is; that means, what, the investors can get more you know earnings out of it. So, it strengthens the dollar ok.

A possible decline in Indian interest rates. Suppose, there is a decline in the Indian interest rates so, what will happen? The dollar will get strengthened why because people would take away the Indian of money from the Indian market and maybe put it in somewhere where in some other markets ok.

Central banks expected to intervene to boost the rupee. Suppose, the central bank it is expected that the RBI would intervene to appreciate or increase the value of the rupee in such a condition what will happen to the dollar? The dollar will get weakened because automatically when the rupee will increase it is value the dollar which is a counter currency or a currency which is you can say exchange you can take it for exchange that becomes automatically weakened.

So, these are some of the consequences and these are the you know cause and effects that can happen. Let us look at this example. Investors think the Mexican economy is too weak right. Example, it has a large current account deficit, high inflation and external debt. So, it has a current account deficit, high rate of inflation and high external debt, nothing can be more worse than this.

Anticipating the currency's fall, speculators who do not own it. Speculators are somebody who do not own. Get rid of their holdings of Mexican pesos in a selling frenzy. So, they tend to sell it without they want to make more money. So, they want to sell it right. So, this lack of demand causes the peso's value to fall right. If speculators thing the Peso will rise in the future they will demand more of it to make a profit causing the value to rise.

So, speculators although it is bad, but sometimes speculators also have a because it is sentimental, they do have a serious effect on the fall or a rise of the currency.

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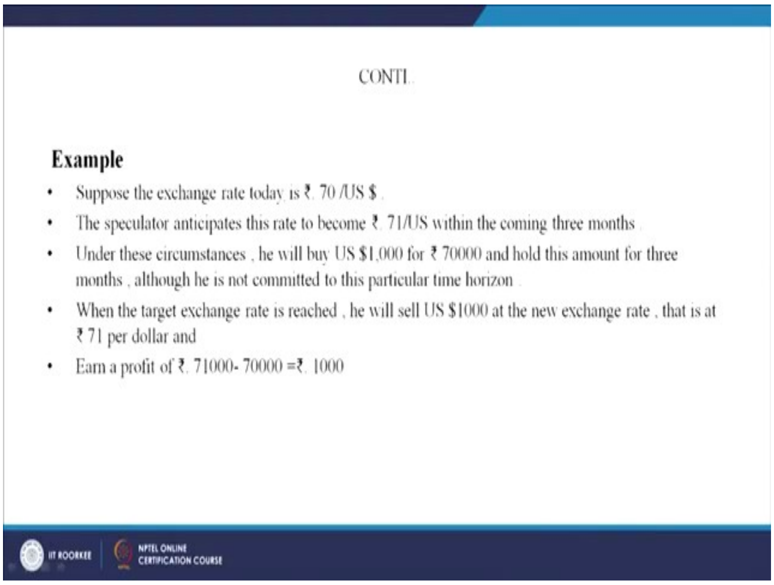

Let us take this example. Suppose the exchange rate today is 1 rupee 1 US dollar is 70 rupees which is actually 71.19 whatever. The speculator anticipates this rate to become 71. So, one there will be an increase of 1 rupee within the coming 3 months ok.

Under the circumstances, what he will do? He will buy 1000 US dollars for how much? 70 into 1000 and hold this amount for three months although he is not committed to the particular time horizon. So, he may sell it just tomorrow if it reaches 71 or maybe 5 days or within three months whatever right. When the target exchange is reached rate is reached he will sell at the new exchange rate that is at 71, earn a profit of 1000 right.

So, you can understand how the speculators and the participants in the forex market make their difference, make their money right.

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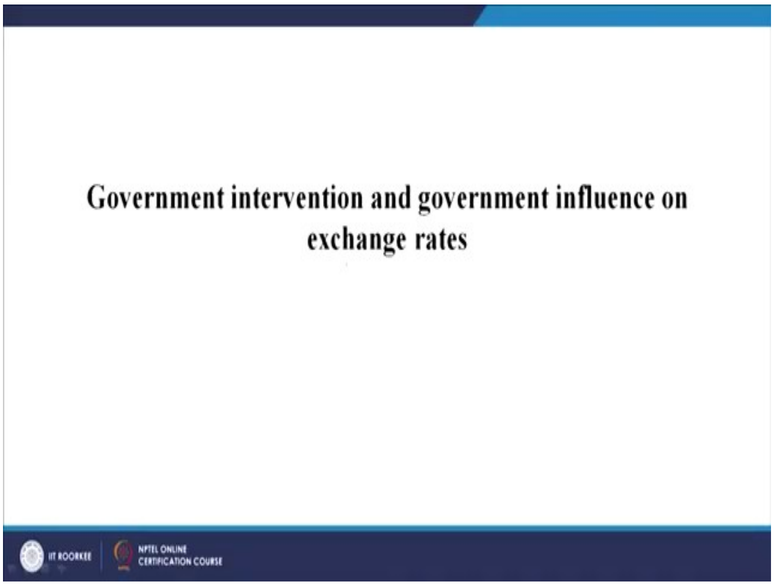

Now, from the factors affecting their foreign exchange, now we will come into the government intervention and exchange rates. So, we will today discuss more about the exchange rates, how this exchange rates are decided and what happens in this right what are the types of exchange rate systems.

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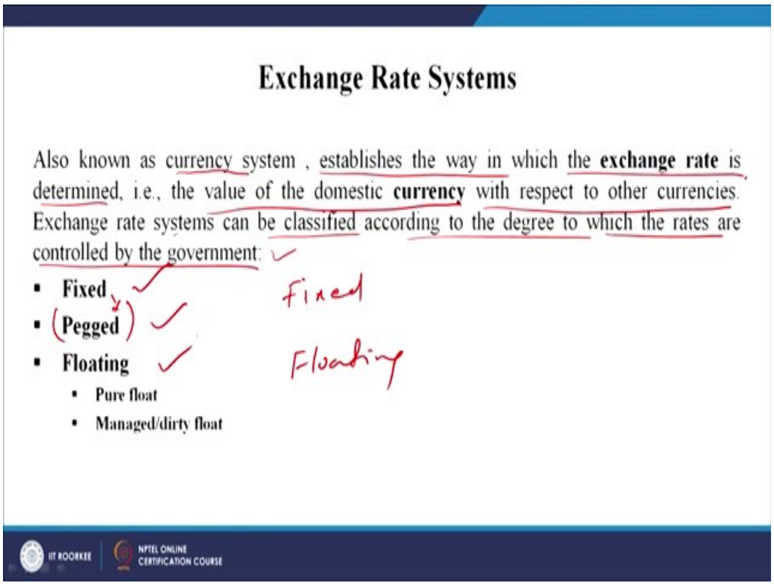

Also known as currency system, the exchange rate system establishes the way in which the exchange rate is determined right; that means, here we are determining the exchange rate. So, when you said 1 dollar is 71 rupees or I said 1 dollar is 71, how did I say that? On what basis? I saw it from some you know from the market maybe data, but how did the market come to that conclusion that it is 71 rupees, why not it is 72 rupees, why not it is 70 rupees right?

So, that is the value of the domestic currency with respect to other currencies ok. Exchange rate systems can be classified according to the degree to which the rates are controlled by the government. So, exchange rate is you know that one value for the other, but this systems are dependent on certain factors. Now, for example, it depends on how much the government can control it. Just think about any economy.

Now, India is one of a one economy there is the US, there is Britain, there is a Switzerland, there is Spain, Norway, Pakistan, Afghanistan, Nepal. So, all countries are trading with each other right. Now, sometimes it is necessary because and the conditions are also highly volatile all the time the markets are in a dynamic state, they are moving they are fluctuating right.

So, the sometimes the governments interventions are also important. So, how does it how is this exchange rates are controlled? Now, here the exchange rates the exchange rates are there are three systems through which it is managed. In fact, basically it is called it is of two types – so, fixed and float. It is called fixed and floating.

So, the exchange rate systems are of two types, one is fixed and floating fixed actually pegged this one comes in the fixed only right, but it can be separately also seen. So, that is why we are made it three, right. So, fixed, pegged and floating right exchange rate systems.

So, let us see each one of them what they are and what do they mean.

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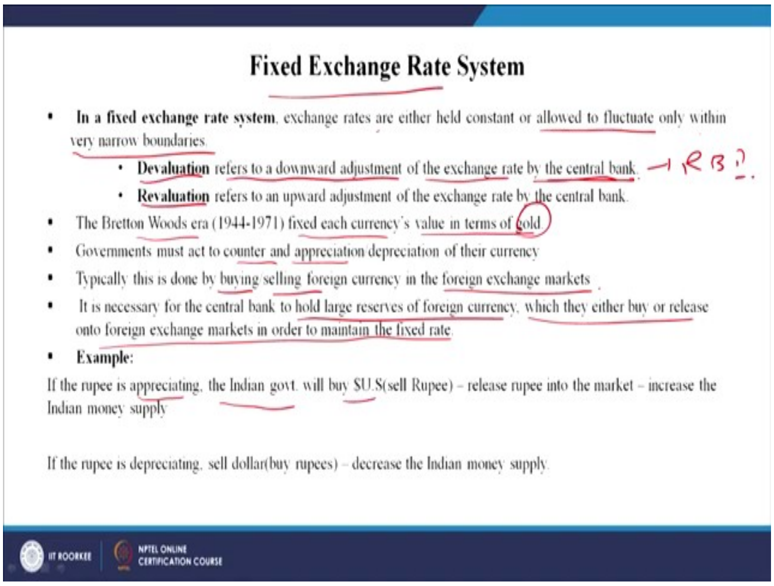

So, let us go to the first as the name suggest fixed exchange rate system. So, I think you can understand we all understand fixed; so, that means, it is it will not move, it will stick as it is right. In a fixed exchange rate system exchange rates are either held constant or allowed to fluctuate only within very narrow boundaries.

What is it saying? That the in the fixed exchange rate system the exchange rates are either held constant or allowed to fluctuate within very narrow boundaries; that means, there is a ceiling. So, upper and the lower ceiling, the floor and the ceiling upper ceiling right. So, you can transact in or you can fluctuate in between this right. So, 1 to 2 dollars or 1.5 to 2 dollars so, whatever the ceiling has been decided you can fluctuate only that much, anything beyond that the government would intervene.

Now, devaluation and revaluation, what does it mean? Devaluation refers to a downward adjustment of the exchange rate by the central bank. So, whenever the you know the central bank finds a situation and it wants to adjust, devalue the currency you must have heard about China and Japan very popular cases where they wanted to devalue their currency right.

So, why do they devalue their currency? The government wants sometimes to devalue their own currency because it would just to boost up their exports right. So, this refers to a downward adjustment done by the central bank; central bank in our case is the RBI right.

Revaluation means refers to an upward adjustment of the exchange rate by the central bank. Now, how much should we make it stronger right at what rate should we fix because to although the word stronger looks positive, but it is it may it is not actually positive because it has an effect on the entire business right. If you are your business is getting your currency is getting stronger the automatically your exports and imports are also affected ok.

The Bretton Woods era fixed each currency value in terms of gold right. So, gold was the measurement basis of measurement right. So, we used to compare our currencies in terms of the gold. The government must act to counter and appreciation or depreciation of their currency. What it says? The government should counter or take steps to control the appreciation or the depreciation of their currency; as we have discussed because it affects the entire trading.

Typically, this is done by buying or selling the foreign currency in the foreign exchange markets. So, if you buy the currency or you sell the currency that will change the foreign exchange impact or the value right.

It is necessary for the central bank to hold now this is interesting because India in the past did not use to have very large reserves of foreign currency. But, today India is in a very stable position in this point of view that India has large reserves of foreign currency; that means, what it acts like a buffer right you an inventory because in cases of emergency you would require.

In 1991 we had a problem when our currency reserves were completely depleted where at a very low position. So, India was in a very difficult situation at that time right. So, we had in fact, all thanks to the then finance minister and prime minister, but it was also a kind of an emergency and in which we had to open up our economy. Otherwise there was no way we could you know survive in the time.

So, what it says is every country a central bank need to hold large reserves of foreign currency which they either buy or lease onto the foreign exchange markets in order to maintain the fixed rate.

So, in order to maintain their let us say 1 dollar is equal to 70 rupees I want to maintain it. Now, in the actual market in the open market it is fluctuating it is either moving up or moving down. In order to keep at that constant 70, the RBI or the central bank has to sell or buy the rupee; so that the value of the dollar it has it maintains their constant value with the dollar.

Let us see this example is the rupee is appreciating the government will buy US dollars the rupee is appreciating. So, the government what it does it sells the rupee it sells the rupee in the foreign exchange market right and that means, releases the rupee into the foreign exchange market – increases the money supply Indian money supply. So, by that it tries to control the appreciation right.

On the other hand, if the rupee is depreciate it is coming down so, what does it do? It buys the rupee from the foreign exchange market because the rupee depreciates when large amount of rupee is available. So, the RBI would give up at the dollars and buy the rupees, so that the rupees value do not go down right. So, this is very important.

So, this these two aspects are very very important and very critical to understand and this has a large profound impact on the international transactions ok.

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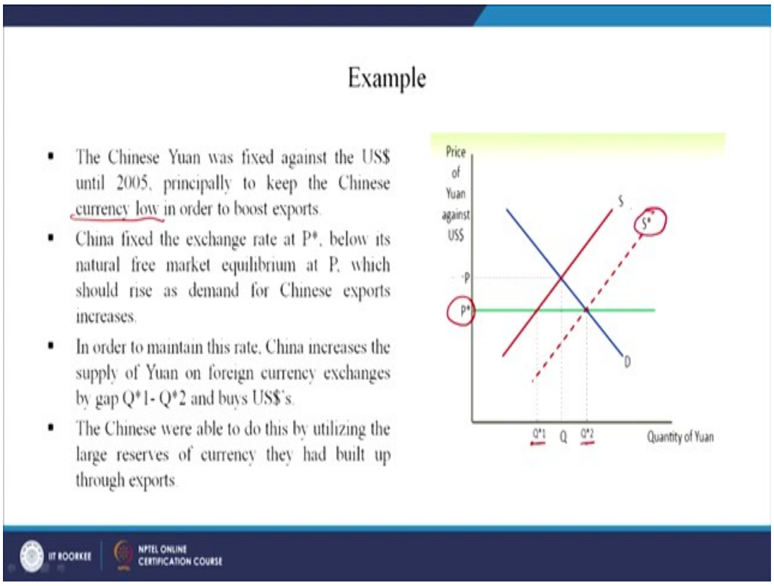

Let us take this example. The Chinese Yuan was fixed against the US dollar until 2005 right, principally to keep the Chinese currency low in order to boost exports right. So, the Chinese wanted the Chinese government wanted to keep the currency low to boost up their exports.

China fixed the percentage rate at P. So, this is if you can see. So, this is price of one against the US dollar right. So this is first case right below its natural free market equilibrium at P. So, the natural market equilibrium is actually at P, but the Chinese government wanted to keep at below the market equilibrium the market value right which is at P star which should rise as this would naturally rise as demand for Chinese exports increases automatically more money would come in. So, right this would also appreciate.

In order to maintain this rate, China increases the supply of Yuan. What it does in order to maintain this rate China increases the supply of Yuan on foreign currency exchanges by gap Q 1 minus Q 2. So, Q 1 this is Q 1 minus Q 2. So, this amount is what they are increasing the supply of Yuan right. So, if you look at it this is how initially the Chinese government wanted this right. So, this is the you know a point.

So this is the S star supply, so, P star supply. So, this is the how the Q 2 this is the Q 2 the quantity of Yuan required. So, as what it says in order to maintain the China increases the supply of Yuan in the market on the foreign currency exchanges. The by doing this the Chinese were able to utilize the large reserves of currency that built up through exports.

So, in order to what they did in order to maintain that rate the china increased the supply of Yuan. So, they gave up a more Yuan into the you know foreign exchange market. So, that the Yuan would come down the value of Yuan will come down and the dollar would become more strengthened.

So, this would help them in their exports right. So, this is what they did and this helped them to you know they did it by utilizing the large reserves of currencies right. So, as you go back and you will see so, if the rupee is appreciating the government will buy or sell the rupee. So, that is what they did, release the Yuan in this case it is rupee, but in that case it is the Yuan into the market increase the Chinese money supply. So, that is how they controlled they brought it down right.

Today we will only stop here and we will continue with the same right foreign exchange systems rate systems in the coming lecture and I hope you have understood what it basically means and how it affects the export, import and the entire business transactions right. So, this is all for today.

Thank you very much.