UNIT 4

FOREIGN EXCHANGE RATE & EXCHANGE RATE REGIMES

- **Foreign Exchange Rate** is a price of one country currency in relation to other country currency
- It is the amount of domestic currency that must be paid in order to get a unit of foreign currency.
- As per **Purchasing Power Parity theory**, the foreign exchange rate is determined by the relative purchasing powers of the two currencies.
- An **exchange rate regime** is the system that a country's monetary authority, -generally the central bank-, adopts to establish the exchange rate of its own currency against other currencies.
- Each country is free to adopt the exchange-rate regime that it considers optimal, and will do so using mostly monetary and sometimes even fiscal policies.

TYPES OF EXCHANGE RATE REGIMES

1. Fixed Exchange Rate

- Under this system, the **government or central bank determines the official exchange rate** by linking the exchange rate to the price of gold or major currencies like the US dollar.
- The government also **intervenes if the exchange rate fluctuates** due to any reason and makes sure that equilibrium predetermined level is maintained.
- The only merit of a fixed exchange rate system is that it **assures the stability of exchange rate**. It prevents both currency appreciation and depreciation.
- However this systems has some glaring disadvantages
- For one, it puts a **heavy burden on governments to maintain exchange rates**. During the time of deficits, for example, the governments need to infuse a lot of money to maintain the exchange rate.
- The **foreign investors usually avoid investing** in such countries. They fear losing their investments because the exchange rate may not reflect the true value of the economy.

2. Floating Exchange Rate

- In such a system, the true value of the exchange rate is **determined freely by the market forces of demand and supply**.
- If due to any reason exchange rate fluctuates, the **government never intervenes** and allows the market to function
- This arrangement gives many advantages.
- It helps in **building trust among foreign investors** as the exchange rate usually **reflects the true value** of the domestic currency.

- In such cases a country can **easily access funds/ loans** from IMF and other international institutions.
- However, floating exchange rate systems **can be volatile.** The exchange rate fluctuates a lot on a day to day basis.

3. Managed Floating Exchange rate

- Managed Floating exchange rate is the middle ground between the two extremes of fixed and floating exchange rate.
- This system merges the best of both systems. Under normal circumstances, the exchange is allowed to move freely and determined by market forces (Demand and Supply).
- But when a difficult situation arises, the central banks of the country **can intervene to stabilise the exchange rate**.
- Currently, India follows this system for determining exchange rate of Indian rupee.

There are different sub-categories under managed floating exchange rate as follows:

Adjusted Peg System:

- In this system, a country tries to hold on to a fixed exchange rate system for as long as it can, i.e. until the country's foreign exchange reserves get exhausted.
- Once the country's foreign exchange reserves get exhausted, the country should undergo devaluation of currency and move to another equilibrium exchange rate.

Crawling Peg System:

- Here, a country keeps on adjusting its exchange rate to new demand and supply conditions.
- Instead of devaluing currency at the time of crisis, a country will follow regular checks at the exchange rate and when required undertakes small devaluations.

Clean Floating:

- The exchange rate is determined by market forces of demand and supply.
- The exchange rate appreciates or depreciates as per market forces and with no government intervention.
- It is identical to a floating exchange rate system.

Dirty Floating:

- The exchange rate is to a very large extent determined by the market forces of demand and supply (so far identical to clean floating).
- But occasionally the central banks of the countries intervene in foreign exchange markets to smoothen or remove excessive fluctuations from the foreign exchange markets.

Liberalized Exchange Rate Management System (LERMS):

- LERMS was introduced from March 1, 1992 under which the **rupee** was **made partially convertible**.
- This **Dual Exchange Rate System** was introduced following the recommendations of the **High Level Committee on Balance of Payments** constituted under Chairmanship of Mr. **C. Rangarajan**.
- This system **combined official and market determined exchange rates.**
- The objective was to encourage exporters and induce a greater inflow of remittances through proper channels as well as bring about greater efficiency in import substitution.
- Under the system, **60% percent** of eligible foreign exchange receipts such as exports earnings or remittances was to be converted at the market rate and the **balance 40%** at the official rate of exchange.
- Importers could obtain their requirements of foreign exchange from authorized dealers at the market rate.
- Because of certain weaknesses, this system was replaced by **Unified Exchange Rate System,** in March 1993.
- This unification was recommended as an important step towards full current account convertibility by the committee on balance of payments under the chairmanship of C Rangarajan.
- Under the unified rate system all foreign exchange transactions through authorized dealers out at market determined rate exchange.
- The **RBI however, did not relinquish its right to intervene** in the market to enable orderly control.

Factors That Influence Currency Exchange Rates

Factors that influence currency exchange rates are important for various reasons. For countries, these factors can affect how one country trades with another. For individuals, these factors affect how much money one can get when exchanging one currency for another. Although it is not always easy to understand, track, or even anticipate these factors, it pays to know them, especially if you are interested in foreign currency. It is worth noting that these factors affect currency exchange rates at a macroeconomic level, meaning they affect global currency exchange rates and not local exchange rates.

1. Inflation

Inflation is the relative purchasing power of a currency compared to other currencies. For example, it might cost one unit of currency to buy an apple in one country but cost a thousand units of a different currency to buy the same apple in a country with higher inflation. Such differentials in inflation are the foundation of why different currencies have different purchasing powers and hence different currency rates. As such, countries with low inflation typically have stronger currencies compared to those with higher inflation rates.

2. Interest Rates

Interest rates are tightly tied to inflation and exchange rates. Different country's central banks use interest rates to modulate inflation within the country. For example, establishing higher interest rates attracts foreign capital, which bolsters the local currency rates. However, if these rates remain too high for too long, inflation can start to creep up, resulting in a devalued currency. As such, central bankers must consistently adjust interest rates to balance benefits and drawbacks.

3. Public Debt

Most countries finance their budgets using large-scale deficit financing. In other words, they borrow to finance economic growth. If this government debt outpaces economic growth, it can drive up inflation by deterring foreign investment from entering the country, two factors that can devalue a currency. In some cases, a government might print money to finance debt, which can also drive up inflation.

4. Political Stability

A politically stable country attracts more foreign investment, which helps prop up the currency rate. The opposite is also true – poor political stability devalues a country's currency exchange rate. Political stability also affects local economic drivers and financial policies, two things that can have long term effects on a currency's exchange rate. Invariably, countries with more robust political stability like Switzerland have stronger and higher valued currencies.

5. Economic Health

Economic health or performance is another way exchange rates are determined. For example, a country with low unemployment rates means its citizens have more money to spend, which helps establish a more robust economy. With a stronger economy, the country attracts more foreign investment, which in turn helps lower inflation and drive up the country's currency exchange rate. It is worth noting here that economic health is more of a catch-all term that encompasses multiple other drivers like interest rates, inflation, and balance of trade.

6. Balance of Trade

Balance of trade, or terms of trade, is the relative difference between a country's imports and exports. For example, if a country has a positive balance of trade, it means that its exports exceed its imports. In such a case, the inflow of foreign currency is higher than the outflow. When this happens, a country's foreign exchange reserves grow, helping it lower interest rates, which stimulates economic growth and bolsters the local currency exchange rate.

7. Current Account Deficit

The current account deficit is closely related to the balance of trade. In this scenario, a country's balance of trade is compared to those of its trading partners. If a country's current account deficit is higher than that of a trading partner, this can weaken its currency relative to that country's currency. As such, countries that have positive or low current account deficits tend to have stronger currencies than those with high deficits.

8. Confidence/ Speculation

Sometimes, currencies are affected by the confidence (or lack thereof) traders have in a currency. Currency changes from speculation tend to be irrational, abrupt, and short-lived. For example, traders may devalue a currency based on an election outcome, especially if the result is perceived as unfavorable for trade or economic growth. In other cases, traders may be bullish on a currency because of economic news, which may buoy the currency, even if the economic news itself did not affect the currency fundamentals.

9. Government Intervention

Governments have a collection of tools at their disposal through which they can manipulate their local exchange rate. Primarily, central banks are known to adjust interest rates, buy foreign currency, influence local lending rates, print money, and use other tools to modulate currency exchange rates. The primary objective of manipulating these factors is to ensure favorable conditions for a stable currency exchange rate, cheaper credit, more jobs, and high economic growth.

INTERNATIONAL BUSINESS NEGOTIATION

The process of Business negotiation goes from a situation of 'Contention' to one of 'Conclusion'. Contention means that each party starts from a different point concerning what he or she hopes to achieve through negotiations. Conclusion refers to final agreement between the two parties on what they will achieve to reach a common goal.

Distinctive features of International business negotiations

The first is that in international negotiations **the parties must deals with the laws, policies and political authorities of more than one nation**. These laws and policies may be inconsistent, or even directly opposed. For example, in the early 1980s U.S. companies operating in Europe were caught between the American prohibition on sales to the Soviets for their Trans-Siberian pipeline, and European nations' demands that these companies abide by their supply contracts. International business agreements must include measures to address these differences. Such measures typically include arbitration clauses, specification of the governing laws, and tax havens.

A second factor unique to international business is the **presence of different currencies.** Different currencies give rise to two problems. Since the relative value of different currencies varies over time, the actual value of the prices or payments set by contract may vary, and result in unexpected losses or gains. Another problem is that each government generally seeks to control the flow of domestic and foreign currencies across their national boundaries. And so business deals will often depend upon the willingness of governments to make currency available. Unexpected changes in such governmental currency policies can have dramatic effects on international business deals.

A third element common to international business negotiations is the **participation of governmental authorities**. Governments often play a much larger role in foreign business than they are accustomed to. The presence of extensive government bureaucracies can make international negotiation processes more rigid that is usual in the private sector. Sovereign immunity can introduce legal complications into contracts. State-controlled businesses may have different goals from private companies. Whereas private firms are usually primarily concerned with profits, state entities may be willing to sacrifice some profitability for social or political ends such as greater employment.

Fourth, **international ventures are vulnerable to sudden and drastic changes in their circumstances**. Events such as war or revolution, changes in government, or currency devaluation have an impact on international businesses which is much greater than the impact than the usual domestic changes have on national businesses. These risks require the international business negotiator to have a breadth of knowledge and social insight that would not ordinarily be necessary in negotiating a business arrangement..International businesses try to protect against these risks by employing political risk analysts, by foreign investment insurance, and by force majeure clauses which allow for contract cancellation under certain conditions.

International business negotiators also encounter very different ideologies. In particular, different countries may have very different ideas about private investment, profit and individual rights. Effective negotiators will be aware of ideological differences. They will present their proposals in ways that are ideologically acceptable to the other party, or that are at least ideologically neural.

Finally, **cultural differences** are an important factor in international negotiations. In addition to language differences, different cultures have differing values, perceptions and philosophies. As a result, certain ideas may have very different connotations in different cultures. For instance, Americans and Japanese tend to have a different view of the purpose of negotiations. Americans see the goal of negotiations as to produce a binding contract which creates specific rights and obligations. Japanese see the goal of negotiations as to create a relationship between the two parties; the written contract is simply an expression of that relationship. What the Japanese see as a reasonable willingness to modify a contract to reflect changes in the parties relationship, Americans see as a tendency to renege. American insistence on adherence to the original terms of the contract may be perceived as distrust by the Japanese.

Some cultures prefer to start from agreement on general principles, while other prefer to address each issue individually. Some cultures prefer to negotiate by "building up" from an initial minimum proposal; other prefer to "build-down" from a more comprehensive opening proposal.

Future Trends in International Business

Trends in international business are important to follow. They help your business react quickly to change to remain relevant, improve customer acquisition and retention, and save your company valuable time and money.

Here are a few of the trends experts anticipate for 2020 and why they're important for international business.

Environmentally-Friendly Technologies

Local, state and federal governments continue to strengthen environmental measures. Going green now may help a business get ahead of the curve, and they may enjoy tax benefits when they adopt innovative techniques and processes now, instead of later.

Besides regulatory compliance, environmentally-friendly technologies can also lead to long-term savings. Increasing energy efficiency, minimizing waste, and adopting innovative software to streamline processes are all excellent methods to help a business reduce their environmental impact and spend less.

The growing concern for the environment has also led consumers and businesses to re-examine the products and services they buy. Fortunately, going green can help build trust, extend a company's market base, make the company a more attractive option for employees and improve its standing in the community and business world.

Tailored Artificial Intelligence Platforms

Many companies already use AI or are considering it because it can improve business operations and customer service. Until recently, most companies could only afford to access AI through broad as-a-service platforms that required expensive custom engineering to meet a company's specific needs.

In 2020, companies can expect to see a larger pool of providers other than the current tech giants. They'll offer tailored services and applications for specialized or specific tasks, making AI available to SMEs too.

According to Adobe's 2019 CIO Perspectives Survey, almost 80% of chief information officers at U.S. companies plan to increase the use of artificial intelligence and machine learning in 2020.

IDC predicts 75% of enterprises will embed intelligent automation into technology and process development by 2022 and by 2024 AI will be integral to every part of their business.

Adoption of 5G

No company can afford to ignore mobile technology, and 5G is likely to be very popular as it delivers more speed, reduced latency and a smoother online experience.

Besides the obvious benefits to buyers, 5G can also improve teamwork and business agility. Early 5G adopters may have a distinct advantage over slower competitors.

Ericsson reports the uptake of 5G is happening more quickly than expected. They predict 5G networks will carry 35% of the global mobile traffic by 2024.

Broader Blockchain Application

Initially, blockchain technology supported Bitcoin. Today, it demonstrates many other uses for business due to its enhanced security and decentralized ownership.

In 2019, Gartner predicted "the business impact of the blockchain will be transformational across most industries within five to 10 years." Banking, investment services, and retail are most likely to show interest, but McKinsey & Company suggests it could benefit any business.

For instance, blockchain can improve efficiency and secure smart contracts and transactions, regardless of the number of contracts or cross-border payments. It can also increase supply chain transparency and counteract theft and fraud. Gartner suggests blockchain will support the movement and tracking of $2T of goods and services annually by 2023.

Greater Need for Data Privacy & Protection

The growing threat of cybercrime makes the protection of data more important than ever. Companies must take proactive measures if they want to gain new clients, retain their existing client base and meet ever-increasing data privacy regulations.

In 2020, cloud and mobile security measures will take the forefront as business and consumer rely more heavily on off-site storage and mobile devices. Building consumer trust and effective customer relationship management remain paramount for business success.

Gig Economy Grows

The need for skilled workers in foreign countries increases as businesses expand globally. Luckily, according to a report issued by BCG Henderson Institute, gig platforms increase access to a variety of talent difficult to source through traditional labor markets. This is especially true in emerging countries where gig work has grown by more than 30%.

Those living in the region often have advanced skills and in-depth area knowledge. Many countries are focusing on a national workforce and impose legislative barriers on foreign workers. Hiring internally sidesteps this issue.

In 2020, expect to see more freelance and contract work as it often preferred by workers and business. Many people don't want to commit to full-time employment and companies may want to test the waters before they commit to an employee.

Single-Firm Outsourcing

Most companies see the benefits of outsourcing many of their in-house functions such as payroll, accounting and HR. However, few have the time or inclination to juggle multiple companies. It makes lateral communication and reporting almost impossible.

Upcoming trends that may affect any business

As you start preparing for the international growth of your business or even if you are only selling on the local land, it is worth considering how the following trends could affect your business.

- **Emerging Markets**
  India has now become one of the fastest-growing economies in the world. The business-class is increasing, and there is an increase in demand for quality goods and services. If you want your business to grow rapidly, you have to consider selling into one of the emerging markets. Language, financial stability, economic system and culture are all various factors that will influence which markets you should target.

- **Speed of Innovation**
  The ever-increasing pace of technology and innovation has forced a hand on many companies to come up with new and improved products. International companies can not expect to be automatically at the forefront of technological advancements, and this trend will intensify as more businesses in developing countries acquire the expertise to innovate successfully.

- **Instant Access to More Product Information**

More intense and rapid communications allow customers anywhere and everywhere to purchase products manufactured all around the globe. They are also given access to all the information about what they are about to buy and what alternatives and cheaper options are available in the market. As information is easily available thanks to the internet, businesses are more pressurized to remain active online and to promote a positive brand image and product presence in every social arena.