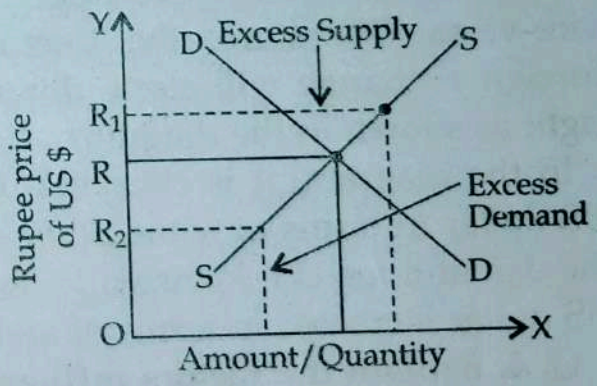
7. Exchange Rate Determination. Factors affecting exchange rate—Relative inflation rates, relative interest rates, relative income levels, government controls, expectations, etc. Government intervention and government influence on exchange rates. Theories of exchange rate—Purchasing Power Parity, Interest Rate Parity and Fisher's effect.

Q. 1. Explain how exchange rate is determined in a free market?

Ans. The foreign exchange rate is determined with the forces of demand for and supply of in the foreign exchange market. In other words, demand supply theory applies with regard to the determination of exchange rate. As such the equilibrium rate of exchange will be determined with the help of forces of demand for and supply of foreign exchange.

There is a functional relation between foreign currency rate and demand for foreign currency. This relation between the two is inverse. This means when exchange rate is high, demand for foreign exchange will be low and vice-versa. As such the demand curve for foreign currency will slope downwards to the right. In the diagram given below DD is the demand curve.

The relation between rate of currency and supply of foreign currency is direct. This means supply of foreign currency will be more when exchange rate is more and vice-versa. As such supply curve (SS) as shown in the diagram will rise upwards to the right. The equilibrium exchange rate is determined at a point where demand for and supply of foreign currency is equal. If rate other than this is fixed, either there will be excess of supply or demand as the case may be. As shown in the diagram, the equilibrium exchange rate is OR. At OR_1 rate, there is excess of supply equal to MN and at OR_2 rate, there is excess of demand equal to AB.



Q. 2. What do you mean by supply of foreign exchange? What are its sources?

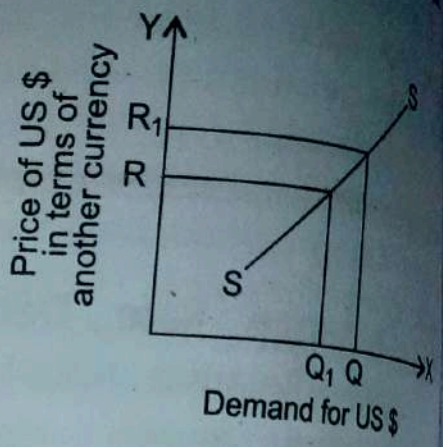
Ans. The supply of foreign currency is the amount of foreign currency in a country. It comes from the following sources:

(i) Payments available to domestic suppliers for the good/services they have exported.

(ii) The amount which foreigners invest in the home country on purchasing goods and services.

(iii) Foreign currencies flow into the economy due to currency dealers and speculators.

The relationship between exchange rate and supply of foreign exchange is direct. It implies that supply of foreign exchange will be more when exchange rate of a foreign currency is more and vice-versa. Because of that supply curve rises upwards to the right as shown in the following diagram.



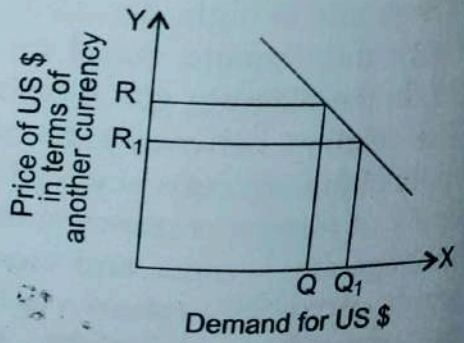
When the price of US dollar increases, supply of US dollar also increases for now more goods can be bought from India and vice-versa.

Q. 3. What do you mean by demand for foreign exchange? What are its determinants?

Ans. The demand for foreign exchange signifies the amount of foreign currency which is demanded by a home country say India. Hence, it means how much foreign currency is demanded by a particular country. The demand for foreign currency is generally made for the following reasons:

(i) For making payments to foreign country against imports.
(ii) For making investments and lending by domestic residents.
(iii) For sending or making payments for unilateral transfers like gifts, donations etc.
(iv) To speculate on the value of foreign currency.

There is an inverse relationship between the demand for foreign exchange and its price. It implies that demand for foreign exchange will be more when foreign exchange rate is low and vice-versa. Therefore, the demand curve for foreign exchange will slope downwards to the right as shown in the diagram .



In the diagram, it is clear that when price of US dollar in terms of some other currency falls, the demand for US dollar will increase. The reverse of it happens when price of US dollar increases in terms of another currency.

Q. 4. Explain the factors influencing exchange rate determination.

Ans. Foreign exchange rate is one of the most important means through which a country's relative level of economic health is determined. A country's forex rate provides a window to its economic stability which is why it is constantly watched.

Following are some of the leading factors influencing exchange rate determination:

1. **Relative inflation rates.** Usually a country with a lower inflation rate exhibits a rising currency value as its purchasing power increases relative to other currencies. Those countries with higher inflation witness depreciation in the value of their currency in relation to the currencies of their trading partners. This is usually accompanied by higher interest rates.

Relative interest rates. Differentials in interest rates also influence exchange rate determination. By manipulating interest rates, central banks exert influence over both inflation and exchange. Higher interest rates offer lenders a higher return as compared to other countries. Therefore, higher interest rates attract foreign capital and cause the exchange rate to rise. The impact of higher interest rates is mitigated, however, if a country's inflation is much higher or if additional factors drive the value of their currency down. The reverse relationship exists for decreasing interest rates.

3. **Current Account Deficits.** The current account is the balance of trade between a country and its trading partners, reflecting all payments between countries for goods, services, interest and dividends. A deficit in the current account shows a country is importing goods and services more than it is exporting them. The country will then borrow capital from foreign sources to make up the deficit causing its currency to depreciate relative to its trading partner.

4. **Public Debt.** Nations with large public deficits and debts are less attractive to foreign investors. This is because a large debt encourages inflation in the economy, consequently higher inflation leads to lower value of currency.

5. **Terms of trade.** Terms of trade refers to ratio of comparing export prices to import prices. If the price of a country's exports rises by a greater rate than that of its imports, its terms of trade have favorably improved, which tends to indicate currency appreciation. On the other hand, if the price of a country's imports rises more than the rate of exports, their currency's value will decrease in relation to trading partners.

6. **Political stability and Economic performance.** Foreign investors look for the stable countries having good economic performance in which they can invest their capital. Political instability can cause a loss of confidence in a currency and ultimately results in movement of capital to the currencies of more stable countries.

7. **Relative income levels.** Income levels influence currencies through consumer spending. When incomes increases, people spend more. Higher demand for imported goods increases demand for foreign currencies and hence weakens the local currency. On the other hand, when people are not able to buy imported items due to low incomes level demand for foreign currencies fall, strengthening the local/domestic currency.

8. **Government intervention and control.** Some governments attempt to influence the value of their currency. Government buys or sells foreign currency to influence the exchange rate of its own currency. Usually central banks intervene in foreign exchange markets in order to achieve various economic objectives like price stability, controlling inflation and deflation etc. Under certain circumstances the government might want to intervene in the foreign exchange markets to influence the level of the exchange through changes in exchange rates, reserves and borrowing etc.

For example, China has sought to keep its currency undervalued to make Chinese exports more competitive.

9. **Speculation.** If a country's currency value is expected to rise, investors will

demand more of that currency in order to make a profit in the near future. 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.

Q. 5. Write a short note on Exchange Rates. [2015

Ans. Exchange Rates. Exchange rate defines the price of a nation's currency in terms of another currency. An exchange rate has two components, the domestic currency and a foreign currency, and can be quoted either directly or indirectly. In a direct quotation, the price of a unit of foreign currency is expressed in terms of the domestic currency. In an indirect quotation, the price of a unit of domestic currency is expressed in terms of the foreign currency. An exchange rate that does not have the domestic currency as one of the two currency components is known as a cross currency, or cross rate. An exchange rate has a base currency and a counter currency. In a direct quotation, the foreign currency is the base currency and the domestic currency is the counter currency. In an indirect quotation, the domestic currency is the base currency and the foreign currency is the counter currency. Most exchange rates use the US dollar as the base currency and other currencies as the counter currency. However, there are a few exceptions to this rule, such as the euro and Commonwealth currencies like the British pound, Australian dollar and New Zealand dollar.

The main exchange rate systems include:

1. **Fixed exchange rates.** A fixed exchange rate system, or pegged exchange rate system, is a currency system in which governments try to maintain a currency value that is constant against a specific currency or good. In a fixed exchange-rate system, a country's government decides the worth of its currency in terms of either a fixed weight of an asset, another currency, or a basket of other currencies. The central bank of a country remains committed at all times to buy and sell its currency at a fixed price.

To ensure that a currency will maintain its "pegged" value, the country's central bank maintain reserves of foreign currencies and gold. They can sell these reserves in order to intervene in the foreign exchange market to make up excess demand or take up excess supply of the country's currency. The most famous fixed rate system is the gold standard, where a unit of currency is pegged to a specific measure of gold.

2. **Floating exchange rates.** A floating exchange rate, or fluctuating exchange rate, is a type of exchange rate regime wherein a currency's value is allowed to fluctuate according to the foreign exchange market. A currency that uses a floating exchange rate is known as a floating currency. The dollar is an example of a floating currency. Many economists believe floating exchange rates are the best possible exchange rate regimes because these regimes automatically adjust to economic circumstances. These regimes enable a country to dampen the impact of shocks and foreign business cycles, and to pre-empt the possibility of having a balance of payments crisis. However, they also give rise to unpredictability as the result of their dynamism.

A genuine free float would involve leaving exchange rates entirely to the vagaries of supply and demand on the foreign exchange markets, and neither

intervening on the market using official reserves of foreign exchange nor taking exchange rates into account when making interest rate decisions. The Monetary Policy Committee of the Bank of England clearly takes account of the external value of sterling in its decision-making process, so that although the pound is no longer in a fixed exchange rate system, it would not be correct to argue that it is on a genuinely free float.

The central bank of countries using a managed float will attempt to keep currency relationships within a predetermined range of values (not usually publicly announced), and will often intervene in the foreign exchange markets by buying or selling their currency to remain within the range.

Q. 6. How do inflation and interest rates influence the value of the currency? Explain.

Ans. The rate of inflation in a country has a major impact on the value of its currency and the rates of foreign exchange it has with the currencies of other nations. Inflation is more likely to have a significant negative impact on a currency's value and foreign exchange rate. An extremely high rate of inflation is very likely to impact the country's exchange rates with other nations. Inflation is closely related to interest rates, which can influence exchange rates. Higher interest rates tend to attract foreign investment which is likely to increase the demand for country's currency. However, higher interest rates often cause increasing inflation rates, which is a negative influence on the country's currency.

Low interest rates increase consumer spending and economic growth and usually have a positive impact on currency value but they are not capable of attracting foreign investment. Hence, interest rate and inflation are the major factors influencing value of a currency.

Q. 7. Give a brief account of Foreign Exchange risks. How are these risks managed? *[2015*

Ans. *Foreign Exchange Risk.* The risk of investment value changing due to changes in the currency's exchange rate is known as foreign exchange risk. The risk that an investor will have to close out a long or short position in a foreign currency due to adverse movement of exchange rate is also known as currency risk or exchange rate risk. This risk usually affects businesses that are involved in export or import but it can also affect investors making international investments. *For example,* if money must be converted to another currency to make a certain investment, then any future changes in the currency exchange rate will cause that investment value to either increase or decrease when the investment is sold and converted back into original currency.

Methods of managing foreign exchange risks:

1. **Forward contracts.** The forward market is where you can buy and sell a currency, at a fixed future date for a predetermined rate, *i.e.* the forward rate of exchange. This effectively fixes the future rate. Forward exchange contracts are used extensively for hedging currency transaction exposures.

Advantages include. It fixes the future rate, thus eliminating downside risk exposure flexibility with regard to the amount to be covered. It is relatively straightforward both to comprehend and to organize.

Disadvantages include. Contractual commitment that must be completed on the due date (option date forward contract can be used if uncertain). It provides no opportunity to benefit from favourable movements in exchange rates.

2. **Money market hedges.** The basic idea is to avoid future exchange rate uncertainty by making the exchange at today's spot rate instead. This is achieved by depositing/borrowing the foreign currency until the actual commercial transaction cash flows occur. This effectively fixes the future rate. The money markets are markets for wholesale (large-scale) lending and borrowing, or trading in short-term financial instruments. Many companies are able to borrow or deposit funds through their bank in the money markets. Instead of hedging a currency exposure with a forward contract, a company could use the money markets to lend or borrow, and achieve a similar result. Since forward exchange rates are derived from spot rates and money market interest rates, the end result from hedging should be roughly the same by either method.

3. **Futures contracts.** Futures contracts are standard sized, traded hedging instruments. The aim of a currency futures contract is to fix an exchange rate at some future date, subject to basis risk.

4. **Options.** A currency option is a right, but not an obligation, to buy or sell a currency at an exercise price on a future date. If there is a favourable movement in rates the company will allow the option to lapse, to take advantage of the favourable movement. The right will only be exercised to protect against an adverse movement, *i.e.*, the worst-case scenario. A call option gives the holder the right to buy the underlying currency. A put option gives the holder the right to sell the underlying currency. Options are more expensive than the forward contracts and futures but result in an asymmetric risk exposure.

5. **Forex swaps.** In a forex swap, the parties agree to swap equivalent amounts of currency for a period and then re-swap them at the end of the period at an agreed swap rate. The swap rate and amount of currency is agreed between the parties in advance. Thus it is called a fixed rate/fixed rate swap. The main objectives of a forex swap are:

- To hedge against forex risk, possibly for a longer period than is possible on the forward market.
- Access to capital markets, in which it may be impossible to borrow directly.
- Forex swaps are especially useful when dealing with countries that have exchange controls and/or volatile exchange rates.

6. **Currency swaps.** A currency swap allows the two counter parties to swap interest rate commitments on borrowings in different currencies. In effect a currency swap has two elements—

(*i*) An exchange of principal in different currencies, which are swapped back at the original spot rate-just like a forex swap.

(*ii*) An exchange of interest rates-the timing of these depends on the individual contract. The swap of interest rates could be fixed for fixed or fixed for variable.

Q. 8. Briefly explain central bank intervention in foreign exchange markets.

Or

Write a short note on foreign exchange market /currency intervention.

Ans. A central bank will buy or sell a currency in the foreign exchange market in order to increase or decrease the value of its nation's currency. This is known as *currency intervention* or *foreign exchange market intervention*. When a country's currency is enduring extreme and unnecessary upward or downward financial pressure, a government or central bank will use foreign exchange market intervention to stabilise the situation. Central bank intervention can be used to boost or decrease a currency's value, most commonly for the purpose of boosting exports of a nation. It is believed that export dependent countries could spiral into recession if it becomes too reliant on market intervention. Global trading partners exchange rates will rise while the prices of their exports increase within the global market. A decline in value of a nation's currency can lead to an increase in inflation as prices of imported items will go up.

Subsequently, interest rates will be augmented by the central bank but will disturb the economic growth and asset market. This may lead to decline in currency's value. Countries with large budget deficits rely on foreign inflows of capital. A decline in the value of a currency can cause major financial difficulty to countries with high budget deficits. Financing the deficits will be extremely delayed and will jeoparadize the growth process of a nation. In order to maintain the value of the currency, there will need to be an elevation of interest rates.

Central bank intervenes in foreign exchange markets by using the following methods:

1. **Direct intervention.** The most direct way for central banks to intervene and affect the exchange rate is to enter the private forex market directly by buying or selling domestic currency. There are two possible transactions.

First, the central bank can sell domestic currency in exchange for a foreign currency. This transaction will raise the supply of domestic currency causing a reduction in the value of the domestic currency. Hence, when domestic currency depreciates the foreign currency in question will appreciate. Since the central bank is the ultimate source of domestic currency, it can flood the forex market with domestic currency. Hence, the central bank can depreciate the value of domestic currency.

The central bank can also raise the value of domestic currency by buying domestic currency in exchange for foreign currency. It must have a stockpile of foreign currency known as foreign exchange reserves. These reserves are accumulated over time and held in case an intervention is desired.

2. **Sterilized foreign exchange intervention.** Direct forex intervention will change the domestic money supply. It can have an inflationary pressure on the economy. Hence sterilized intervention is used to cause a change in the exchange rate while at the same time leaving the money supply. This does not influence interest rates and hence does not create inflationary pressure on the economy. A sterilized foreign exchange intervention occurs when a central bank counters direct intervention in the forex market with a simultaneous offsetting transaction in the domestic bond market. *For example,* in order to lower the value of domestic currency, the central bank may sell domestic currency and buy foreign currency. Sterilization in this case involves an open market operation in which it sells treasury bond at the same time and in the same value as the domestic currency in the forex market.

Q. 9. Write short noes on:

(a) Floating Exchange Rate System

(b) Exchange Rate System of Managed Float

Ans. (a) ***Floating Exchange Rate System.*** The Floating Exchange Rate System is a mechanism where a nation's currency's value is set by the foreign exchange market through supply and demand for that particular currency relative to other currencies. Thus, floating exchange rates change freely and are determined by trading in the forex market. This is opposite to a "fixed exchange rate" regime. *For example,* if a currency's value moves in any one direction at a rapid and sustained rate, the Central Bank intervenes by buying and selling its own currency reserves (*i.e.*, Federal Reserve in the US) in the foreign exchange market in order to stabilize the local currency. However, central banks are reluctant to intervene, unless absolutely necessary, in a floating regime.

***The key arguments for flexible exchange rates*:**

(*i*) Easier external adjustments

(*ii*) National policy autonomy

Suppose a country is experiencing a BOP deficit. This means that there is an excess supply of country's currency at the prevailing exchange rate in the foreign exchange market. Under a flexible exchange rate system, the external value of the country's currency will simply depreciate to the level at which there is no excess supply of the country's currency. At the new exchange rate level, the BOP disequilibrium will disappear.

As long as the exchange rate is allowed to be determined by market forces, external balance will be achieved automatically. The government does not have to take policy actions to correct the BOP disequilibrium. It can use its monetary and fiscal policies to pursue its economic goals.

(b) ***Exchange Rate System of Managed Float.*** A Managed Float system is an exchange rate regime in which the country's central bank occasionally intervenes to change the direction or the pace of change of the country's currency value. In most instances, the intervention aspect of a dirty float system is meant to act as a buffer against an external economic shock before its effects become truly disruptive to the domestic economy. It's also known as a "Managed Float." From 1946 until 1971, many of the world's major industrialized nations participated in a fixed exchange rate system known as the Bretton Woods Agreement. This ended when President Richard Nixon took the United States off the gold standard on August 15, 1971; Since then, most major industrialized economies feature floating exchange rates. Many developing nations seek to protect their domestic industries and trade by using a managed float in which the central bank intervenes to guide the currency. The frequency of such intervention varies. For example, the Reserve Bank of India manages the rupee closely in a very narrow band, while the Monetary Authority of Singapore allows the local dollar to fluctuate more freely in an undisclosed band.

Q. 10. Briefly explain the Purchasing Power Parity Theory.

Or

What is meant by purchasing power parity?

Ans. PPP (Purchasing Power Parity) is an economic theory that estimates the

amount of adjustment needed on the exchange rate between countries in order for the exchange rate to be equivalent to each currency's purchasing power.

PPP is calculated as:

$$S = \frac{P_1}{P_2}$$

...where
- S Represents currency 1 to currency 2
- P_1 Represents the cost of good X in currency 1
- P_2 Represents the cost of good X in currency 2

According to this theory the exchange rate adjusts so that an identical good in two different countries has the same price when expressed in the same currency. In simple words, PPP is a theory which states that exchange rates between currencies are in equilibrium when their purchasing power is the same in each of the two countries. PPP is used world-wide to compare the income levels in different countries. It makes it easy to understand and interpret the purchasing power of the countries.

The basis for PPP is the 'law of one price'. In the absence of transportation and other transaction costs, competitive markets will equalize the price of an identical good in two countries when the prices are expressed in the same currency.

The theory aims to determine the adjustments needed to be made in the exchange rates of two currencies to make them at par with the purchasing power of each other. In other words, the expenditure on a similar commodity must be same in both currencies when accounted for exchange rate. The purchasing power of each currency is determined in the process.

For example, suppose a pair of shoes costs ₹2,400 in India. Then it should cost $40 in America when the exchange rate is ₹60 between the dollar and the rupee.

Q. 11. What do you understand by price level ratio of PPP (Purchasing Power parity) conversion factor to market exchange rate?

Ans. Purchasing power parity conversion factor refers to the number of units of a country's currency required to buy the same amount of goods and services in the domestic market as a foreign currency would buy in its own country. The ratio of PPP conversion factor to market exchange rate is the result obtained by dividing the PPP conversion factor by the market exchange rate. The ratio also referred to as the national price level, makes it possible to compare the cost of the bundle of goods that make up gross domestic product across countries. It tells how many units of foreign currency are required to buy foreign currencies' worth of goods in the country as compared to the united states.

Q. 12. What is the relevance of PPP?

Ans. The concept of PPP is useful in comparing quality or standard of living in different countries which may not be possible if one just looked at per capita income. A lower income may allow a good quality of life in a country of low prices. For instance, a haircut may cost lot more in London than in New Delhi. The major shortcoming of PPP exchange rates is that these are difficult to measure.

Q. 13. What is meant by Interest Rate Parity?

Ans. The economic theory of interest rate parity states that the difference between the interest rate in two countries is equal to the differential between the forward rate and the spot rate of those two countries. This equality does not always exist and thus allows traders to arbitrage options position to earn risk less

returns. For interest rate parity to exist, there must be easy capital mobility between countries, along with complete substitutability of assets. For instance, a deposit in a foreign bank is considered the same as a deposit in a domestic bank.

If the nominal returns were different between the domestic and foreign deposits, investors would move their money to the bank paying the higher nominal return. Interest rate parity exists when the expected nominal rates are the same for both domestic and foreign assets. Any difference is due to expected appreciation or depreciation in the foreign or domestic currencies. *For example,* if the domestic interest rate is 8% and the foreign interest rate is 5%, this means that the market expects the foreign currency to appreciate by 3% or the investors expect the domestic currency to depreciate by 3%. In this case the investor can invest in a foreign deposit and then convert the foreign currency to his domestic currency or can invest in domestic deposit and then can convert the domestic currency to the foreign currency. Either option will produce the exact same cash flow.

Q. 14. Explain with the help of an example, the interest rate parity theory of exchange rate.

Ans. The Interest Rate Parity condition can be used to develop an exchange rate determination model. Interest rate parity or covered interest parity condition provides equilibrium to the financial market. According to this theory, the cost of money (*i.e.,* the cost of borrowing money or the rate of return on financial instruments), when adjusted for the cost of covering foreign exchange risk, is the same across different currencies. This theory assumes the total absence of transaction costs, taxes and capital controls, providing the investors and traders with an atmosphere of free trade.

The above theory can be explained in detail, with the help of the following example:

Consider trading of currencies between India and US. If interest rate parity holds, then the rate of return on dollar deposits equals the expected rate of return of Indian rupees.

$$RoR_{\$} = RoR_{₹}$$

The above can be written as:

$$I_{\$} = \frac{I_{₹} + F(E\$/₹) + E\$/₹}{E\$/₹} (1 + Ir_{₹})$$

where –

$I_{\$}$ is interest rate prevailing in the US

$I_{₹}$ is interest rate prevailing in India

F (E$/₹) is the forward exchange rate

E$/₹ is spot exchange rate between the dollar and the rupee

From the data given below we can find the best country for purchasing a one-year interest-bearing asset.

Consider the following data on interests rate and exchange rates in the US and India:

$I_{\$}$	5.45% per year
$I_{₹}$	3.65% per year

F(E$/₹)	2012	0.6369 $/₹
E$/₹	2001	0.6944 $/₹

We assume that decision is to be made for the year 2001; therefore, we take 2002 rates as the expected exchange rates and use 2000 rates as the current spot rates. Thus, the ex-post, (*i.e.*, after the fact) rate of return on India deposits is given by,

$$\text{RoR}_{₹} = 0.365 + \frac{0.6369 - 0.6944 \times (1 + 0.0365)}{0.6944}$$

A negative rate of return means that the investor would have lost money (in dollar terms) by purchasing Indian assets.

Since $\text{RoR}_{\$} = 5.45\%$ and $\text{RoR}_{₹} = -4.93\%$, an investor seeking the highest rate of return should deposit his money in the US account.

Q. 15. In what circumstances will the interest rate parity theory not hold?

Ans. ***Cases when Interest Rate Parity does not hold good:***

(*i*) **Transaction Cost.** The transaction cost involved in the money market operations is the difference between the investment and borrowing rate. In other words, the costs incurred while investing in one market and/or borrowing in another, and converting one currency into another. The theory of Interest Rate Parity assumes this cost to be NIL since otherwise, arbitrage opportunities will exist for borrowers and investors. The presence of these costs will allow deviations to the extent of the costs involved.

(*ii*) **Political Risks.** Political risks arise when an investor invests in deposits denominated in foreign currency held domestically. *For example,* a French citizen may hold a dollar deposit with a London Bank. This additional risk forces investors to seek a higher rate of return on investment than warranted by interest parity. This factor allows deviations from the parity to take place.

(*iii*) **Capital Controls.** This is one of the major factors, which casues deviation from interest parity. Capital controls include restriction on investing or borrowing abroad, and on repatriation of investments made by foreign residents. Because of these controls, the interest rate in Euro-markets (where capital controls do not apply) is more in line with parity, than the domestic interest rates in different countries.

Q. 16. Write a brief note on Fisher's Effect.

Or

Explain the theory of Fisher's effect.

Ans. 'Fisher's effect' is an economic theory proposed by the economist **Irving Fisher** that describes the relationship between inflation and both real and nominal interest rates. The Fisher's effect states that *"the real interest rate equals the nominal interest rate minus expected inflation rate. Therefore, real interest rates fall as inflation increases, unless nominal rates increase at the same rate as inflation". For example,* if the nominal interest rate on a savings account is 4% and the expected rate of inflation is 3%, then money in the savings account is actually growing at 1%. The smaller the real interest rate the longer it will take for savings deposits to grow substantially.

The interest rate an investor has in a savings account is actually the nominal interest rate. Hence the **fisher's** theory describes the relationship between inflation and both real and nominal interest rates.

Real interest rate = The nominal interest rate – Expected inflation rate.

International Fisher Effect States *"that an expected change in the current exchange rate between any two currencies is approximately equivalent to the difference between the two countries nominal interest rates for that time".*

For *example,* if country A's interest rate is 10% and country B's interest rate is 5%, country B's currency should appreciate roughly 5% compared to country A's currency. According to Fisher, country with a higher interest rate will also tend to have a higher inflation rate. The increased amount of inflation should cause the currency in the country with the high interest rate to depreciate against a country with lower interest rates.

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