Hello everyone, Welcome! Today,

we will be discussing about the

topic, ‘Managed Float, spot and

forward exchange rates and the

factors influencing exchange rates’,

which is from the unit titled,

Foreign exchange market

and exchange rates. I am Dr. Anna Rovina Fernandes,
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Here

is the module outline.
The concept of managed floating system;
Managed float or dirty float;
Reasons why countries adopt Managed Floating;
Currency exchange rates-spot and forward rates;
The link of forward rate with spot rate;
The factors affecting exchange rates
and we will wind up with
Summary.
On completion of this module,
you will be able to understand the
hybrid system called as managed floating.
You will be able to differentiate
between spot and forward exchange rates
and analyze the factors
affecting exchange rates.

So shall we begin?

What is the managed floating system?

After the breakdown of the Bretton

Woods system of fixed exchange rates.

since 1973,

the world has moved to a

hybrid exchange rate system,

which combines both the fixed and

flexible exchange rate systems into what

is called as managed floating system.

A managed floating exchange rate

system is an international financial

arrangement whereby central banks

intervene in the exchange rate

determination only periodically,

not necessarily to support

the country's currency,

but with the main objective to

stabilize volatile fluctuations

in foreign exchange rates.

Managed float is a floating exchange

rate in which the government

intervenes at some frequency to

change the direction of the float.

And it does this by buying and

selling currencies by acting

as a market participant.

So. the central banks intervene only to

moderate the short run fluctuations

through using to a very limited extent,

the foreign exchange Reserves.

Such a policy reduces the short

run fluctuations in the exchange

rate without affecting the long

term market trends.

The objective of intervention here

is to secure the benefits that

result from fixed exchange rates

and at the same time to retain

the flexibility in adjusting the

balance of payments disequilibria.

In 1973 the IMF adopted

informal guidelines for coordination

of national exchange rate policies and

the main reason for these guidelines

was that freely floating exchange

rates might lead to disorderly markets

with erratic fluctuations in exchange rates.

The managed float,

in fact, is a dirty float.

What is a dirty float?

A dirty float is a floating exchange rate,

where country's central bank occasionally

intervenes to change the direction,

and the pace of change of a country's

currency value.

In most instances,

the central bank in a dirty float acts

as a buffer against external economic

shocks to prevent erratic fluctuations

which can disrupt the domestic economy.

The managed float is referred to

as a dirty float because there is

central bank intervention within the

flexible exchange rate system in

order to influence the exchange rate.

And it is not completely market determined,

but there is just periodic

intervention by the central bank,

as we have noted, as a market participant.

This can be contrasted with a

clean float system where the central

bank does not intervene at all.

Why do countries adopt managed floating?

The main reasons are as follows.

First, to prevent the market uncertainties.

Central banks sometimes intervene

to steady the market at times of

widespread economic uncertainties.

They do so in order to prevent

speculative attacks on a currency.

Thirdly, they do so in order to achieve

macroeconomic objectives, particularly-

to improve the balance of payments position.

They do so in order to reduce the risk of

recession and to rebalance the economy away from domestic consumption towards exports.

And this can be achieved

through currency depreciation.

In the 1970s decade the common exchange

rate regime adopted by countries

including industrial countries,

was an intermediate regime

of managed floating under which the central banks

intervene in foreign exchange markets,

which also necessitates the maintenance of

adequate stock of foreign exchange reserves.

The debate on appropriate policies related to

foreign exchange markets have now converged

around some commonly accepted views.

Firstly, exchange rate should be more

flexible rather than fixed or pegged.

Countries should be able to

intervene or manage the exchange

rate to at least some degree if they
believe that the exchange rate

movements are destabilizing in the short run,

Thirdly,

the reserve should at least be

sufficient enough to take care

of fluctuations in capital flows,

and if liquidity is at risk.
Now,

let us look at the different

types of currency exchange rates.

Broadly,

there are two different types

of currency exchange rates,

spot and forward exchange rates.

The spot exchange rate is simply

the current exchange rate,

as opposed to the forward exchange rate,

which is a future exchange rate.

Spot foreign exchange rate is the

rate of a foreign exchange contract

which requires the immediate delivery

or exchange of currencies on the spot.

In practice,

the settlement takes place within

two days in most markets. A forward exchange rate essentially refers to an exchange rate that is quoted and traded today, but for delivery and payment on a set future date. It is the rate of exchange applicable to a forward contract, which is an agreement between two parties requiring the delivery at some specified future date of a specified amount of a foreign currency by one of the parties against payment in domestic currency by the other party at the price agreed upon in the contract. Forward exchange contracts are of immense help to exporters and importers as they can cover their risk arising out of exchange rate fluctuations by entering into an appropriate forward exchange contract and by hedging their risk.

For example,

a British company might make a sale of

it’s good to the United States but will not

receive payment for at least one year.

So how is it able to price its

products or goods without knowing

what the foreign exchange rate

will be between the dollar

and the Euro one year from now?

It can do so by entering into a

forward contract that allows it to

lock in a specific rate in one year

so that they can agree upon a set

exchange rate without knowing what the

spot rate will be after one year.

The link of the forward rate with

spot rate.
With reference to the

relationship with the spot rate,

the forward rate may be a par,

discount or premium. If the forward

exchange rate quoted is exactly

equivalent to the spot rate

at the time of making the contract,

the forward exchange rate is

set to be at par.

The forward rate for a currency,

say the dollar is said to be at a

premium with respect to the spot rate

when $1.00 buys more units

of another currency,

say the rupee in the forward,

then in the spot market. The

forward rate for a currency,

say the dollar is set to be a discount

with respect to the spot rate.

When $1.00 buys fewer rupees in the

forward than in the spot market.

The forward exchange rate is

determined mostly by the demand

for and supply of forward exchange.

When the demand for forward

exchange exceeds its supply,

the forward rate will be quoted at a premium,

and conversely,

when the supply of forward exchange

exceeds the demand for it,

the rate will be quoted at discount.

When the supply is equivalent to

the demand for forward exchange,

the forward rate will tend to be at par.

What are the factors affecting

exchange rates? The exchange rate

fluctuates daily with the changing

forces of demand and supply of

currencies in one country and

another country.

Since the introduction of market

determined exchange rates,

notable volatility in exchange rates

have been observed and there are many

factors that cause this volatility.

Let's look at some of the leading factors.

This chart here shows some of

the main factors like inflation,

interest rate,

public debts,

political stability and economic

performance in countries,

terms of trade and the current

account deficit.

Let's see some of these factors

now in detail.

Inflation rates - Changes in market inflation

causes changes in currency exchange rate.

A country with lower inflation rate will see

an appreciation in the value of its currency,

whereas a country with higher inflation

typically sees depreciation in its currency.

Interest rates also affect the exchange rate.

When the interest rates go up,

there tends to be an appreciation

of the country's currency because

it attracts foreign investment.

Another factor is the country's

balance of payments

position. A country with a balance

of payments deficit will tend to

have a depreciating currency.

And a country with a balance

of payments

surplus will tend to have

appreciation of its currency,

Government debt -

government debt is public debt which

is owned by the central government.

If a country is perceived to have

a high national debt without a

credible plan for dealing with it,

that can have a negative impact

on the value of

its currency and the currency

will tend to depreciate.

Terms of trade is another factor.

The terms of trade is the ratio of

export prices to import prices.

A country's terms of trade improve

if its exports prices rise at a

greater rate than its import prices.

This means there is a higher

demand for the country's currency,

leading to its appreciation.

Another factor is the political

stability and economic performance.

A country's political state and

economic performance can give its

currency strength or otherwise.

A country with less risk or

political turmoil is more

attractive to foreign investors,

which can lead to more foreign capital,

and appreciation.

A country which is prone to political

confusion may see a depreciation in

the exchange rates.

Recession -

When a country experiences a recession,

its interest rates are likely to

fall which decreases the chance

to acquire foreign capital and thus

lowering the exchange rate.

Speculation -

If a country's currency value is

expected to rise,

this will attract investors leading to

appreciation of the country's currency.

These determinants of currency

exchange rates are sometimes such

that they affect the long run

exchange rates and some of them

affect the short run exchange rates.

The determinants of Long run exchange

rate usually are relative price levels,

consumer preferences for domestic

vs foreign goods and the

country's trade policy,

whereas in the short run

the most influencing factors

are relative interest rates and

expected changes in exchange rates.

Let's now summarize our discussion.

A managed floating exchange rate

system is an international financial

arrangement whereby central banks

intervene only periodically,

not necessarily to support the

country's currency,

but rather to stabilize the volatile

fluctuations in foreign exchange rates.

The managed float is a dirty float

because there is central bank

intervention within the flexible

exchange rate system.

There are two different types

of currency exchange rates,

spot and forward exchange rates.

With reference to the relationship

with the spot rate,

the forward rate may be at

par, discount or premium.

The main factors that cause the

supply and demand schedules of

currencies to change causing

changes in exchange rate include

market fundamentals,

such as interest rates, inflation rates,

trade policy, economic conditions,

market expectations, etc.

That's all from me on this topic.

Do check the references for further reading.

Thank you and all the best.