B.A. 3RD SEMESTER

INTERMEDIATE MACROECONOMICS
UNIT-3

INTEREST RATE PARITY AND SOME ADDITIONAL TOPICS

Interest rate parity theory

- As a result of market forces, the forward rate differs from the spot rate by an amount that sufficiently offsets the interest rate differential between two currencies.
- Then, covered interest arbitrage is no longer feasible, and the equilibrium state achieved is referred to as interest rate parity (IRP).
- According to IRP, at equilibrium, the forward rate of a foreign currency will differ (in %) from the current spot rate by an amount that will equalise the interest rate differential (in%) between the home and foreign country.

Difference between spot and forward transactions

- Spot transaction means the exchange of currencies for delivery within two business day or the exchange rate at which the transaction takes place.

- A forward transaction is an agreement to purchase for delivery at a future date at a rate agreed upon today.

- Forward discount – If the forward rate is below the present spot rate then the foreign currency is said to be at a forward discount.

- Forward premium- If the forward rate is above the present spot rate then foreign currency is said to be at forward premium.

Instruments of foreign exchange

- Foreign bills of exchange: it is a written order or request from the drawer to drawee to pay a certain amount of money.

- Telegraphic transfers: it is an important instrument to facilitate a quick transfer of funds from one country to the other.

- Bank draft: it represents an order to pay money on demand. The debtor or importer can get bank draft from his own bank. It is transmitted to the creditor or exporter who will collect the amount from the bank of his own country.

- Letter of credit: it authorises a person to draw a bill or cheque for a specified amount on the issuing bank at stipulated time. The letter of credit shows that the bank issuing the letter of credit has undertaken the responsibility of making payment to the exporter.

Functions of foreign exchange market

- Transfer function: it transfers the funds or purchasing power from one country and currency to another. This function is performed through credit instruments like bills of foreign exchange, bank drafts and telephonic transfers.

- Credit function: The credit function performed by foreign exchange markets also plays a very important role in the growth of foreign trade, for international trade depends to a great extent on credit facilities. Exporters may get pre shipment and post shipment credit. Credit facilities are available also for importers. Thus, the foreign exchange market permits time to the importers in making payment on the one hand and permits instant payments to the exporters.

- Hedging function: Hedging refers to covering of foreign trade risks, and it provides a mechanism to exporters and importers to guard themselves against losses arising from fluctuations in exchange rates. Thus, foreign exchange market is to furnish facilities for hedging exchange risk.