<u>Exchange rate regimes</u>

Exchange rate regime refers to the ‘way’ the value of the domestic currency in term of foreign currencies is determined. It is important to understand terms such as “foreign exchange” and “exchange rate” as they are central to understanding the economy around you.

Foreign Exchange

“Foreign exchange” refers to money denominated in a currency other than the domestic currency. Foreign exchange can be cash, funds available on credit cards and debit cards, travellers’ cheques and banks’ deposits.

Exchange rate

Like any other commodity, foreign exchange has a price. The exchange rate is the price of one currency in terms of another. For example, if the exchange rate between the rupee and the US dollar (USD) is quoted as 13.8435, this means that R13.8435 is required to purchase US$1.00.

Exchange rate regime

As stated above, exchange rate regime refers to the ‘way’ the value of the domestic currency in term of foreign currencies is determined. It is closely related to monetary policy and the two are generally dependent on many of the same factors. Exchange rate regimes can broadly be categorized into two extremes, namely fixed and floating.

In a *fixed* exchange rate regime, the domestic currency is tied to another foreign currency, mostly more widespread currencies such as the U.S. dollar, the euro, the Pound Sterling or a basket of currencies. In a fixed exchange rate system, the government (or the central bank acting on the government's behalf) intervenes in the foreign exchange market to ensure that the exchange rate stays close to a predetermined target. Under this system, exchange rate stability is achieved but if the exchange rate is fixed at the wrong rate it may be at the expense of domestic economic stability.

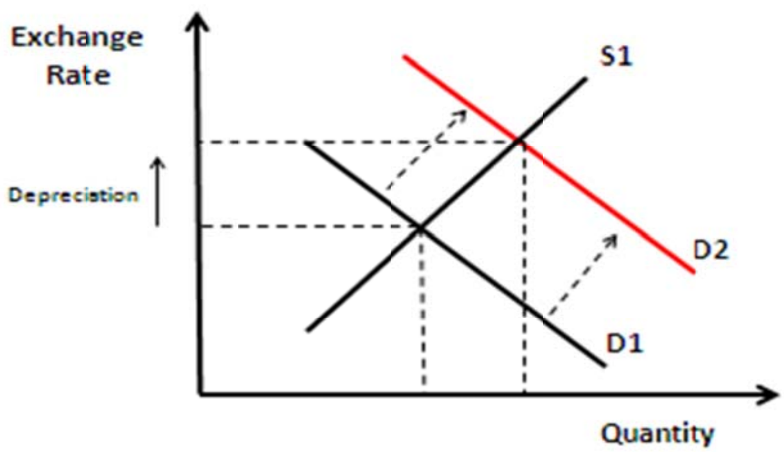
In a fixed exchange rate system, a rise in the exchange rate of the domestic currency vis-à-vis another foreign currency is called a *devaluation*. This means that in order to buy 1 unit of a given foreign currency more of the domestic currency is needed. On the other hand, when the exchange rate falls it is termed as a *revaluation*. These terms imply a deliberate decision on the part of the government to change the level of the exchange rate. For example a government’s policy decision to devalue the domestic currency vis-à-vis the US dollar from R 5.5000 to R6.5000.

Fixed rates provide greater certainty for exporters and importers as there are no or limited exchange rate risks. As businesses have the perfect knowledge that the price is fixed and therefore not going to change, it is relatively easier for them to plan ahead. However, a fixed exchange rate regime may have a high administration cost and as was the case in Seychelles, a significant gap between the official rate and that determined by the market can promote black markets. In a black market the bulk of foreign exchange transactions are carried out outside the banking system. This may force government to draw down on reserves to meet its obligations and cause scarcity of foreign exchange.

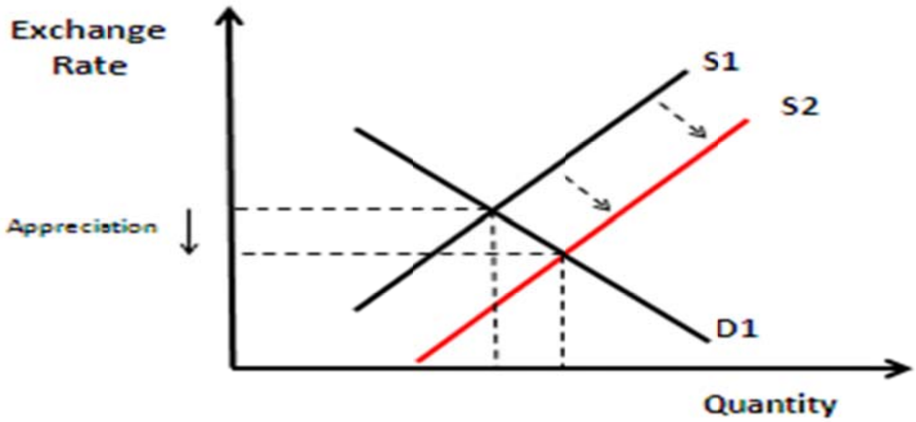
To note that between the two extreme exchange rate regimes there is the *managed float*, (semi-fixed exchange rates) the exchange rate is given a specific target and a central bank keeps the rate from deviating too far from a target band or value. Under this regime, the exchange rate is the main target of economic policy-making (interest rates are set to meet the target).

In a *floating* exchange rate regime, (as currently in place in Seychelles since November 2008) the market's demand for and supply of the currency (i.e. the Seychelles rupees) determines the exchange rate. There is no pre-determined official target for the exchange rate set by the government. The latter and/or the central bank can indirectly influence the exchange rate by managing the level of domestic and foreign currencies in the banking system.

Under a floating exchange rate regime, a rise in the exchange rate of the domestic currency vis-à-vis another foreign currency is called a *depreciation*. This implies that more rupees are required to purchase 1 unit of the foreign currency. Vice versa when less domestic currency is needed it is termed as an *appreciation*. To note, these movements happen more or less freely in response to market forces without any government or central bank interference. Hence, the recent depreciation of the rupee against other major currencies is as a result of market forces namely increased demand (In the graph below, a move from D1 to D2) relative to supply (shown by S1) for foreign exchange and not as a result of interference by the Central Bank of Seychelles (CBS). To note that legally, CBS and the government cannot set the rate.



Changes in foreign exchange supply also have an effect. In the diagram below there is an increase in foreign exchange supply (S1-S2) which puts downward pressure on the market value of the exchange rate leading to an appreciation of the rupee.



If a country has high dependence on imports, for example the Seychelles, more foreign currency leaves the country than the amount that enters. This puts downward pressure on the exchange rate and can cause a depreciation of the local currency. When the depreciation occurs, imported goods will become more expensive in the domestic currency. Using the example of the Seychelles, when the rupee exchange rate moves from R12 to R13 per US dollar, the value of imported goods will increase accordingly. This relationship also holds in the opposite direction.