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The Relationship between Exchange Rate and Capital Market Performance

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ABSTRACT

Exchange rate stability and capital market performance are the twin economic objectives that every country needs to achieve. Foreign investors are busy investing their capital in the stock markets world over. In this process international investment is booming rapidly and capital is moving across all over the world. The benefits of these investors are being determined by foreign exchange rate. Moreover, instability in the exchange rate may bring about uncertainty or otherwise in these investors. Therefore this review paper will highlight the relationship between both the exchange rate and capital market performance in building each country economy.

Keywords: Exchange rate, Capital Market, Performance, Economic, and Investment.

INTRODUCTION

Exchange rate stability is one of the economic objectives that every country needs to achieve. This is because the financial position of every economy being it developed or developing can be assessed from its exchange rate stability. According to [1] a very strong exchange rate is a signal that shows strong and viable economy it is. While on the other hand a very weak currency is a reflection of a very vulnerable and weak economy. Exchange rate instability has real economic shocks because it negatively affects prices level, firms' profits and even the entire activity in an economy. Similarly, capital markets performance plays crucial role in economic development of every nation [2]. Capital markets composed of the suppliers and users of funds. Suppliers include households and the institutions serving them pension funds, life insurance companies, charitable foundations, and non-financial companies that generate cash beyond their needs for investment. Users of funds include home and motor vehicle purchasers, non-financial companies, and governments financing infrastructure investment and operating expenses. Exchange rate and capital market performance are interconnected directly or indirectly, because today, world is turning into a global village due to trade liberalization and globalization [3]. For instance, foreign investors are busy investing their capital in the stock markets world over. In this process international investment is booming rapidly and capital is moving across all over the world. The benefits of these investors are being determined by foreign exchange rate. Moreover, instability in the exchange rate may bring about uncertainty or otherwise in these investors. Thus, exchange rate is the important determinant of capital market performance [4].

The term capital market broadly defines the place where various entities trade different financial instruments. These venues may include the stock market, the bond market, and the currency and foreign exchange markets [5]. Most markets are concentrated in major financial centers including New York, London, Singapore, and Hong Kong. Capital markets are used to sell financial products such as equities and debt securities. Equities are stocks, which are ownership shares in a company. Debt securities, such as bonds, are interest-bearing IOUs.

Classes of Capital Market

These markets are divided into two different categories: primary markets where new equity stock and bond issues are sold to investors and secondary markets, which trade existing securities. These two categories are computer-based electronic platforms [6]. Capital markets are a crucial part of a functioning modern economy because they move money from the people who have it to those who need it for productive use.

Primary Markets

Primary markets are open to specific investors who buy securities directly from the issuing company. These securities are considered primary offerings or initial public offerings (IPOs) [7]. When a company goes public, it sells its stocks and bonds to large-scale and institutional investors such as hedge funds and mutual funds.

Secondary Markets

The secondary market, on the other hand, includes venues overseen by a regulatory body like the Securities and Exchange Commission (SEC) where existing or already-issued securities are traded between investors [8]. Issuing companies do not have a part in the secondary market. The New York Stock Exchange (NYSE) and Nasdaq are examples of the secondary market. It is necessary to note that it also serves an important purpose in capital markets because it creates liquidity, giving investors the confidence to purchase securities.

Corporate Finance

In this realm, the capital market is where investable capital for non-financial companies is available. Investable capital includes the external funds included in a weighted average cost of capital calculation common and preferred equity, public bonds, and private debt that are also used in a return on invested capital calculation [9]. Capital markets in corporate finance may also refer to equity funding, excluding debt.

Financial Services

Financial companies involved in private rather than public markets are part of the capital market [10]. They include investment banks, private equity, and venture capital firms in contrast to broker-dealers and public exchanges.

Public Markets

Operated by a regulated exchange, capital markets can refer to equity markets in contrast to debt, bond, fixed income, money, derivatives, and commodities markets. Mirroring the corporate finance context, capital markets can also mean equity as well as debt, bond, or fixed income markets. Capital markets may also refer to investments that receive capital gains tax treatment [11]. While short-term gains assets held under a year are taxed as income according to a tax bracket, there are different rates for long-term gains [12]. These rates are often related to transactions arranged privately through investment banks or private funds such as private equity or venture capital.

CLASSIFICATION OF EXCHANGE RATE

From the perspective of bank foreign exchange trading

- **Buying rate**: Also known as the purchase price, it is the price used by the foreign exchange bank to buy foreign currency from the customer. In general, the exchange rate where the foreign currency is converted to a smaller number of domestic currencies is the buying rate, which indicates how much the country's currency is required to buy a certain amount of foreign exchange [13].
- **Selling rate**: Also known as the foreign exchange selling price, it refers to the exchange rate used by the bank to sell foreign exchange to customers. It indicates how much the country's currency needs to be recovered if the bank sells a certain amount of foreign exchange.
- **Middle rate:** The average of the bid price and the ask price. Commonly used in newspapers, magazines or economic analysis [14].

According to the length of delivery after foreign exchange transactions

- **Spot exchange rate**: Refers to the exchange rate of spot foreign exchange transactions. That is, after the foreign exchange transaction is completed, the exchange rate in Delivery within two working days [15]. The exchange rate that is generally listed on the foreign exchange market is generally referred to as the spot exchange rate unless it specifically indicates the forward exchange rate.

- **Forward exchange rate**: To be delivered in a certain period of time in the future, but beforehand, the buyer and the seller will enter into a contract to reach an agreement [16]. When the delivery date is reached, both parties to the agreement will deliver the transaction at the exchange rate and amount of the reservation. Forward foreign exchange trading is an appointment-based transaction, which is due to the different time the foreign exchange purchaser needs for foreign exchange funds and the introduction of foreign exchange risk. The forward exchange rate is based on the spot exchange rate, which is represented by the "premium", "discount", and "parity" of the spot exchange rate [17].

According to the method of setting the exchange rate

- **Basic rate:** Usually choose a key convertible currency that is the most commonly used in international economic transactions and accounts for the largest proportion of foreign exchange reserves. Compare it with the currency of the country and set the exchange rate. This exchange rate is the basic exchange rate [18]. The key currency generally refers to a world currency, which is widely used for pricing, settlement, reserve currency, freely convertible, and internationally accepted currency.
- **Cross rate:** After the basic exchange rate is worked out, the exchange rate of the local currency against other foreign currencies can be calculated through the basic exchange rate [19]. The resulting exchange rate is the cross exchange rate.

According to the payment method in foreign exchange transactions

- Telegraphic exchange rate
- Mail transfer rate
- Demand draft rate [20]

According to the level of foreign exchange controls

- **Official rate:** The official exchange rate is the rate of exchange announced by a country's foreign exchange administration. Usually used by countries with strict foreign exchange controls [21].
- **Market rate:** The market exchange rate refers to the real exchange rate for trading foreign exchange in the free market [22]. It fluctuates with changes in foreign exchange supply and demand conditions.

According to the international exchange rate regime

- **Fixed exchange rate:** It means that the exchange rate between a country's currency and another country's currency is basically fixed, and the fluctuation of exchange rate is very small [23].
- **Floating exchange rate:** It means that the monetary authorities of a country do not stipulate the official exchange rate of the country's currency against other currencies, nor does it have any upper or lower limit of exchange rate fluctuations [24]. The local currency is determined by the supply and demand relationship of the foreign exchange market, and it is free to rise and fall.

Factors Affecting the Change of Exchange Rate

Balance of payments:

When a country has a large international balance of payments deficit or trade deficit, it means that its foreign exchange earnings are less than foreign exchange expenditures and its demand for foreign exchange exceeds its supply, so its foreign exchange rate rises, and its currency depreciates [25].

Interest rate level:

Interest rates are the cost and profit of borrowing capital [20]. When a country raises its interest rate or its domestic interest rate is higher than the foreign interest rate, it will cause capital inflow, thereby increasing the demand for domestic currency, allowing the currency to appreciate and the foreign exchange depreciate.

Inflation factor:

The inflation rate of a country rises, the purchasing power of money declines, the paper currency depreciates internally, and then the foreign currency appreciates [21]. If both countries have inflation, the currencies of countries with high inflation will depreciate against those with low inflation. The latter is a relative revaluation of the former.

Fiscal and monetary policy:

Although the influence of monetary policy on the exchange rate changes of a country's government is indirect, it is also very important [22]. In general, the huge fiscal revenue and expenditure deficit caused by expansionary fiscal and monetary policies and inflation will devalue the domestic currency. The tightening fiscal and monetary policies will reduce fiscal expenditures, stabilize the currency, and increase the value of the domestic currency.

Venture capital:

If speculators expect a certain currency to appreciate, they will buy a large amount of that currency, which will cause the exchange rate of that currency to rise [18]. Conversely, if speculators expect a certain currency to depreciate, they will sell off a large amount of the currency, resulting in speculation. The currency exchange rate immediately falls. Speculation is an important factor in the short-term fluctuations in the exchange rate of the foreign exchange market.

Government market intervention:

When exchange rate fluctuations in the foreign exchange market adversely affect a country's economy, trade, or the government needs to achieve certain policy goals through exchange rate adjustments, monetary authorities can participate in currency trading, buying or selling local or foreign currencies in large quantities in the market [23]. The foreign exchange supply and demand has caused the exchange rate to change.

Economic strength of a country:

In general, high economic growth rates are not conducive to the local currency's performance in the foreign exchange market in the short term, but in the long run, they strongly support the strong momentum of the local currency [24].

Manipulation of Exchange Rates

A country may gain an advantage in international trade if it controls the market for its currency to keep its value low, typically by the national central bank engaging in open market operations in the foreign exchange market. In the early twenty-first century it was widely asserted that the People's Republic of China had been doing this over a long period of time [24]. Other nations, including Iceland, Japan, Brazil, and soon have had a policy of maintaining a low value of their currencies in the hope of reducing the cost of exports and thus bolstering their economies. A lower exchange rate lowers the price of a country's goods for consumers in other countries, but raises the price of imported goods and services for consumers in the low value currency country [25]. In general, exporters of goods and services will prefer a lower value for their currencies, while importers will prefer a higher value.

CONCLUSION

The Globe over the years experienced numerous challenges such as exchange rate fluctuations, collapse in economic growth among others especially when there's a pandemic and other threatening events. Stability in exchange rate and favorable growth in the stock market are the key determinants of economic growth of every economy. So therefore in other to enhance the economic growth rate in the country, policies is very essential which will bring more investors into the affected country.

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