Euro - Dollar Parity

Why in News?

Recently, the **Euro and the U.S. dollar reached parity**, meaning **one dollar could buy one euro in the foreign exchange market.**

- Since the beginning of the year, the euro has lost about 12% against the U.S. dollar and it is expected to lose more value going forward.

What determines a Currency Exchange Rate?

- The price of any currency in a market economy is determined by **supply and demand.**
  - The **supply of a country's currency** in the **foreign exchange market** is determined by various factors such as **central bank policy and the local demand for imports and** foreign assets.
  - The **demand for a country's currency**, on the other hand, is determined by factors such as **central bank policy** and the **foreign demand for exports and domestic assets.**

What are the factors behind Fall of the Euro?

- **Divergence in the** monetary policies **of the** U.S. Federal Reserve **and the European Central Bank** is the primary reason behind the euro's significant depreciation against the U.S. dollar.
- **Inflation** in the U.S. hit a four-decade high of 9.1% in June 2022 while inflation in the Eurozone reached its highest-ever level of 8.6% during the same month.
  - The U.S. Federal Reserve responded to the rising prices by **raising the interest rates** this year in order to **slow down U.S.** money supply **growth.**
  - The ECB, however, has been far less aggressive in tightening policy even though the inflation rate is as high as 22% in some European countries.
    - This has caused the **value of the euro to slide against the dollar** as currency traders witness, or at least expect, **the supply of euros in the market rising relative to the supply of dollars.**
- The value of the euro has been affected by the uncertainty in energy supplies in the wake of **Russia's invasion of Ukraine** and the ensuing actions against Russia.
  - Europe now has to **shell out more euros to import limited energy supplies,** which in turn has adversely affected the value of the euro against the U.S. dollar.

How will Euro Dollar Parity Impact the Economy?

- **Business:**
  - Companies that **export outside the euro area benefit** from the euro's fall because their **prices become more competitive when converted into dollars.**
    - Vice Versa, companies that **import from outside in Euro will bear a loss** as they have to pay more Euros for the imports.
  - In the case of local craftsmen, who are dependent on raw materials and energy, but export little, the **weaker euro can lead to a veritable explosion in costs.**
- **Growth and Debt:**
  - The fall in the value of the euro **makes prices outside the single currency area more**

        competitive, theoretically providing a boost to the export of European goods and services abroad.
            - But the positive effect can be mitigated by the **rising prices of commodities in the wake of the war in Ukraine,** particularly in export-oriented economies such as Germany.
        - For countries that issue dollar-denominated debt, the decline in the value of the euro against the dollar pushes up the cost of debt repayment.
- **Central Bank:**
    - By fuelling inflation, the euro's fall **could push the European Central Bank to raise interest rates more rapidly.**
        - It is preparing to tighten borrowing costs for the first time in 11 years in July 2022.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Q. Which one of the following groups of items is included in India's foreign-exchange reserves? (2013)

(a) Foreign-currency assets, Special Drawing Rights (SDRs) and loans from foreign countries
(b) Foreign-currency assets, gold holdings of the RBI and SDRs
(c) Foreign-currency assets, loans from the World Bank and SDRs
(d) Foreign-currency assets, gold holdings of the RBI and loans from the World Bank

Ans: (b)

Explanation:

- Foreign Exchange Reserves are assets kept in reserve by a central bank in foreign currencies.
- According to RBI, Foreign Exchange Reserve in India includes:
    - Foreign Currency Assets
    - Gold
    - SDRs
    - Reserve Tranche Position with IMF
- **Therefore, option (b) is the correct answer.**

Source: TH