



## 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**

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