CHAPTER
FOREIGN EXCHANGE RATE

Meaning

- ❖ **Foreign Exchange**

Foreign exchange refers to foreign currency or all currencies other than the domestic currency. For example, US Dollar, British pound etc. are foreign exchange from the view point of India.

- ❖ **Foreign Exchange Rate**

- The rate at which currency of one country can be exchanged for the currency of the other country is called the rate of foreign exchange.
- In other words it is the price paid in domestic currency in order to get one unit of foreign currency (For example, $1=45).

System or Types of Exchange Rates

There are two broad concepts:

(A) Fixed Exchange Rate System

Meaning

- It is the rate which is officially fixed by the government or financial authority of the country.
- In other words it is the rate which is officially determined in terms of gold or any other currency by the government.

Example

If $1 — 200gm of gold
Rs.50 = 200gm of gold = $1= Rs.50
Now if it changes
$1 = 200gm of gold
Rs.70 = 200 gm of gold = $1 =Rs.70

(B) Flexible Exchange Rate

Meaning

- The system of exchange rate in which rate of foreign exchange is determined by forces of demand and supply of foreign exchange, is called flexible exchange rate system.
- Here value of currency is allowed to fluctuate or adjust freely according to change in demand and supply of foreign exchange. There is no official intervention in foreign exchange market.

R = f (D, S)

- R Exchange Rate
- D = Demand of different currencies in the international market
- S = Supply of different currencies in the international market.

Determination of Flexible Exchange Rate or Equilibrium Exchange Rate

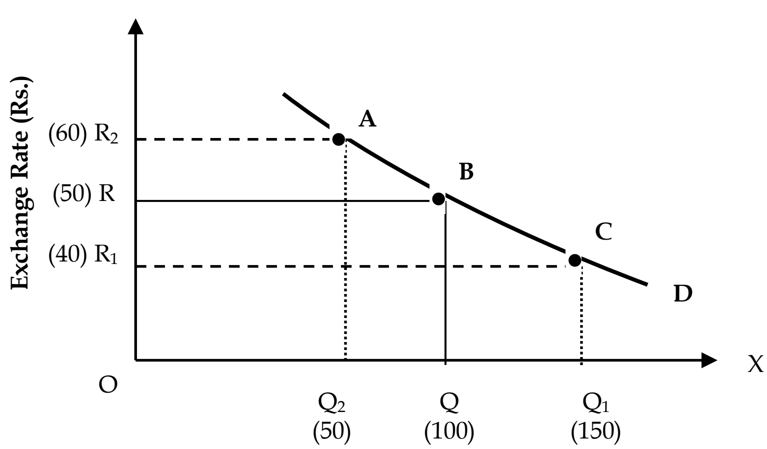
- The value of currency of each country in terms of other currency depends upon the demand for and supply of their currencies.
- According to this theory, the rate of exchange of a country's currency is determined by the demand and supply of foreign exchange.

❖ **Sources of demand for foreign exchange (Say US dollars –S)**

(i) To purchase goods and services from foreign countries.
(ii) To purchase financial assets (to invest in bond and equity shares) in a foreign country.
(iii) To send gifts and grants to abroad (transfer payments).
(iv) To make payments of international trade (imports).
(v) To make payments for international loans.

- There is an inverse relationship between price of foreign exchange (exchange rate) and demand for foreign exchange. When exchange rate rises, demand for foreign exchange falls and vice-versa. That is why; demand curve for foreign exchange becomes downwards sloping. This is due to the fact that the rise in the price of foreign exchange (exchange rate) will increase the rupee cost of foreign goods, which makes them more expensive. As a result, imports will fall. Thus the demand for foreign exchange will also decrease.

Diagram



Demand for foreign exchange ($)

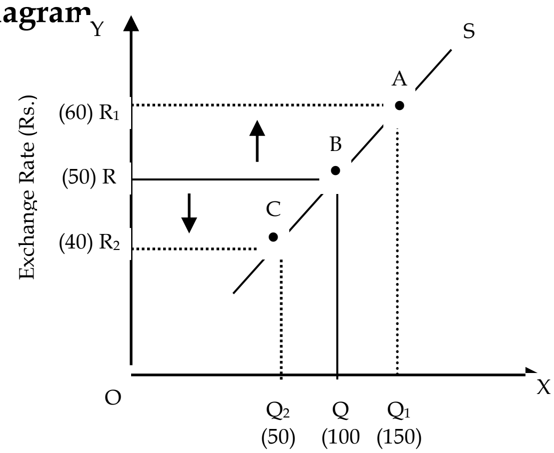
❖ **<u>Sources of supply of foreign exchange: (Say US $ - Dollar)</u>**

- Supply of foreign exchange comes from foreigners who make us payments in foreign exchange (currency) for different purposes.
- Following factors cause supply of foreign exchange:

(i) Exports of the country to the rest of the world
(ii) Direct Foreign Investment (when foreigners invest in the bonds and equity shares of the home country)
(iii) Direct purchase of the goods and services by the non residents in the domestic market
(iv) Speculative purchase by the non-residents in the domestic market.
(v) Remittances (gifts & grants or transfer payments) by the non-residents living in the rest of the world or foreign countries.

- There is a direct relationship between prices of foreign exchange (exchange rate) and supply of foreign exchange. When exchange rate rises, supply of foreign exchange also rises and vice versa. That is why supply curve is upwards sloping. This is due to the fact that the rise in the price of foreign exchange (exchange rate) makes home country's goods cheaper to foreigner since the w.ee ic. rig in value. The demand for exports will increase. Thus, the supply of foreign exchange will also rise.

Diagram



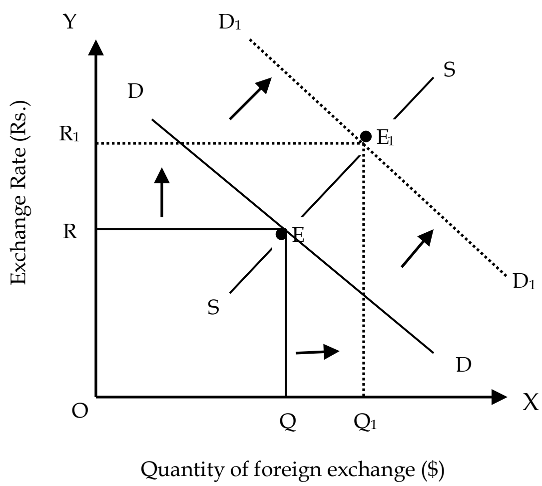
Supply of foreign exchange ($)

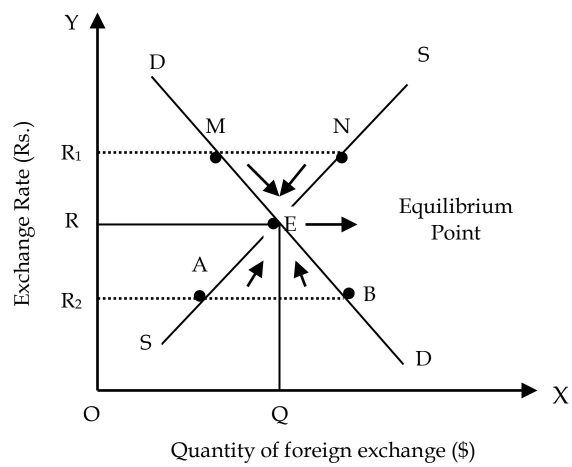
❖ **Equilibrium Exchange Rate**

- Equilibrium exchange rate is determined at a point where demand for and supply of foreign exchange are equal.
- Graphically, intersection of demand and supply curve of foreign exchange determines the equilibrium exchange rate of foreign currency.

Change in Exchange Rate (Depreciation and Appreciation of Currency)
(a) Depreciation of Indian Currency (Increase in the demand for US $ in India)

- Suppose exchange rate is 1$ = 50. An increase in India's demand for US $ will cause the demand curve DD shift to D1D1 The resulting intersection will be at a higher rate. It means exchange rate will rise from OR to OR1 (say 1$ = 60)
- It shows depreciation of Indian currency () because more currency (rupee) is (60 instead of 50) required for buying 1 US S.
- Thus depreciation of a currency means fall in its value in terms of another foreign currency (domestic currency is relatively less valuable).





<u>Effect of Depreciation of Domestic Currency on Exports</u>

Depreciation of domestic currency mean a fall in the price of domestic currency (say rupee) in terms of a foreign currency (say $). It means one $ can be exchanged for more rupees. So with the same amount of dollars more of goods can be purchased from India. It means exports to USA have become cheaper. They may result in increase of exports to USA.

<u>(b) Appreciation of Indian currency (Increase in supply of US $)</u>

- The resulting intersection will be at a lower exchange rate. It means exchange rate will fall from OR to OR1, (say 1$ 40).
- It shows appreciation of Indian currency () because less currency (rupee) (40 instead of 50) are required to buy 1 US $.

<u>Effect of Appreciation of Domestic Currency on Imports</u>

Appreciation of domestic currency means a rise in the price of domestic currency (say rupee) in terms of a foreign currency (say $) It means one rupee can be exchanged for more $. So with the same amount of money (Rupees) more goods can be purchased from USA. It means imports from USA have become cheaper. They may result in increase of imports (from USA).

Devaluation and Revaluation of the Currency

- When a country brings down the value of its currency, in terms of foreign currency by a government order, it is called devaluation. The effect of devaluation is the same as that of depreciation of the currency.
- When a country raises the value of its currency in terms of foreign currency by a government order, it is called revaluation of currency. The effect of revaluation is the same as that of appreciation of currency.

Difference between Devaluation and Depreciation of currency.

Basis	**Devaluation of currency**	**Depreciation of currency**
Meaning	Fall in the value of domestic currency by the government.	Decrease in the value of domestic currency in terms of foreign currency by market forces.
Operation	Takes place due to the government order.	Takes place due to market forces of demand and supply of foreign exchange.
Exchange Rate System	Takes place under fixed exchange rate system.	Takes place under flexible exchange rate system.

Managed Floating

- It is a system in which the central bank allows the exchange rate to be determined by market forces but intervenes at times to influence the rate.
- Central bank does not have absolute power but some power to manage exchange rate slightly according to the economy. Like in the case of surplus or deficit balance of payments (BOP) permission of IMF has to be obtained. It is a system that allows adjustments in exchange rate according to a set of rules and regulations which are officially declared in foreign exchange market.

Foreign Exchange Market

Meaning

- Foreign exchange market refers to the market for national currencies of different countries in the world
- In other words, the market in which national currencies of various countries are converted, exchanged or traded for one another is called foreign exchange market.

Types of Foreign Exchange Market

- There are two types of foreign exchange markets:

(i) Spot Market (ii) Forward Market

(i) Spot Market

- The market in which the receipts and payments of foreign exchange are made immediately, is called spot market.
- Spot market is of daily nature. It deals only in spot transactions of foreign exchange.
- The exchange rate that prevails in the spot market, is called 'spot exchange rate'.

(ii) Forward Market

- The market in which foreign exchange is bought and sold on a specified future date at a rate agreed upon today, is called forward market.
- The exchange rate that prevails in the forward market, is called 'forward exchange rate'.
- Most of the international transactions are occur on forward exchange rate.

Functions of Foreign Exchange Market

(i) Transfer Function

- It implies transfer of purchasing power in terms of foreign exchange across different countries of the world.

(ii) Credit Functions

- It implies provisions of credit in terms of foreign exchange for the export and import of goods and services across different countries of the world.

(iii) Hedging Functions

- It implies protection against the risk related to variations in foreign exchange rate (demand for and supply of foreign exchange is committed at some commonly agreed rate of exchange even when the commitments are to be honoured on some future date).

FOREIGN EXCHANGE RATE

Multiple Choice Questions

Choose the correct option:

1. Price of one currency in relation to other currencies in the international exchange market is known as:
   (a) equilibrium rate (b) fixed exchange rate
   (c) exchange rate (d) flexible exchange rate

2. According to Adjustable Peg System (or Bretton Woods System) of Exchange Rate:
   (a) different currencies were pegged to one currency (US dollar)
   (b) US dollar was assigned gold value at a fixed price
   (c) parity between two currencies was determined by the quantity of gold contained in them
   (d) all of these

3. Under which system, gold was taken as the common unit of countries i in circulation? parity between currencies of different
   (a) Bretton Woods System of Exchange Rate
   (b) Gold Standard System of Exchange Rate
   (c) Flexible Exchange Rate System
   (d) Managed Floating System of Exchange Rate

4. Out of the following, which is the most rigid exchange rate system, which does not allow any adjustment in the exchange rate?
   (a) Flexible Exchange Rate System
   (b) Gold Standard System of Exchange Rate
   (c) Bretton Woods System of Exchange Rate
   (d) None of these

5. The rate which is determined by the government is known as:
   (a) flexible exchange rate (b) fixed exchange rate
   (c) floating exchange rate (d) none of these

6. The exchange rate at which demand for foreign currency becomes equal to its supply, is called:
   (a) equal rate of exchange (b) mint parity
   (c) equilibrium exchange rate (d) all of these

7. What is the relationship between demand for foreign exchange and exchange rate?
   (a) Inverse (b) Direct
   (c) One to one (d) No relationship

8. When supply of foreign exchange increases, the equilibrium exchange rate will rise
   (a) rise (b) fall
   (c) not change (d) either rise or fall

9. Demand for foreign currency depends upon:
   (a) repayment of international loans
   (b) investment in rest of the world
   (c) direct foreign investment in the domestic economy
   (d) both (a) and (b)

10. Due to depreciation of foreign currency, the supply of foreign currency in domestic economy will:
   (a) increase (b) not change
   (c) either increase or decrease (d) decrease

Answers

1. (c)	2. (d)	3. (b)	4. (b)	5. (b)
6. (c)	7. (a)	8. (b)	9. (d)	10. (d)

LONG ANSWER TYPE QUESTIONS (6 MARKS EACH)

1. How is foreign exchange rate determined in a foreign exchange market?

   or

   How is foreign exchange rate determined under a flexible exchange rate system? Use diagram.
2. Distinguish between fixed and flexible exchange rate. Explain using diagram.
3. Explain the effect of depreciation and appreciation of domestic currency on imports and exports.
4. Give the meaning of ‗foreign exchange' and ‗foreign exchange rate'. Giving reason, explain the relation between foreign exchange rate and demand for foreign exchange.
5. Give two sources each of demand and supply of foreign exchange. Giving

reason, explain the relation between foreign exchange rate and supply of foreign exchange.

QUESTIONS FROM SAMPLE PAPER

1. The price of 1 US Dollar has fallen from Rs50 to Rs48. Has the Indian currency appreciated ordepreciated?
2. What is meant by foreign exchange rate?
3. State two sources of supply of foreign currency.
4. Explain the effect of appreciation of domestic currency on imports.
5. Explain the effect of depreciation of domestic currency on imports.

HIGH ORDER THINKING SKILLS (HOTS) QUESTIONS

1. Differentiate between devaluation and depreciation.
2. $ 20 are exchanged for 2000 Indian rupees. What is the exchange rate for Indian currency?[Hint: $ 1 = 100]
3. $10 are exchanged to buy £ 2. What is the exchange rate for US dollars?
4. What does a change from rs100 = $2 to rs80 = $ 2 represent? [Hint:Rs is appreciating and $ isdepreciating]
5. What does a change from Rs100 = $ 2 to Rs140 = S 2 represent? [Hint: $ is appreciating and is Rs depreciating]
6. Explain the effect of depreciation of domestic currency on exports and imports. Hint: (i) exports will increase (ii) imports will decrease]
7. Would the central bank need to intervene in a managed floating system? Explain.
8. Explain the effect of appreciation of domestic currency on exports and imports. Hint: (i) exports will decrease (ii) imports will increase]