11. EXCHANGE RATE AND ITS ECONOMIC EFFECTS

International Trade

↓

Exchange Rate and its Economic Effects

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The Exchange Rate Regimes	Changes in Exchange Rates	Devaluation Vs. Depreciation

Q.No.1. Which market transactions determines the price of one currency in terms of another in India? (B) (SM)

Market transactions involved in determination of price of one currency in terms of another are:

1. Households, businesses and governments in India buy different types of goods and services produced in other countries. Similarly, residents of the rest of the world buy goods and services from residents in India.
2. Foreign investors, businesses, and governments invest in our country, just as our nationals invest in other countries.
3. In the same way, lending, and borrowing also take place internationally.

These and similar other transactions give rise to an international dimension of money, which involves exchange of one currency for another.

SIMILAR QUESTION:

1. Describe how exchange rate is determined?

A. Refer above answer

Q.No.2. Define the term Exchange Rate or Foreign Exchange Rate. (A) (SM)

EXCHANGE RATE OR FOREIGN EXCHANGE RATE:

a) It refers to money denominated in a currency other than the domestic currency. (or)

b) The Exchange rate, also known as a Foreign Exchange (FX) rate, is the price of one currency expressed in terms of units of another currency and represents the number of units of one currency that exchanges for a unit of another. (or)

c) Exchange rate is the rate at which the currency of one country exchanges for the currency of another country.

Characteristics of Exchange rate:

a) Similar to any other commodity, foreign exchange has a price.

b) The value of a currency is relative as it is always given in terms of another currency.

c) It is the minimum number of units of one country's currency required to purchase one unit of the other countries currency.

d) An exchange rate has two currency components: a 'base currency' and a 'counter currency'.

Note: As the US dollar is the dominant currency in global foreign exchange markets, the general convention is to apply direct quotes that have the US dollar as the base currency and other currencies as the counter currency.

SIMILAR QUESTION:

1. Define Exchange rate.

A. Refer the definition

Q.No.3. Explain the two ways to express nominal exchange rate between two currencies. (A) (SM)

There are two ways to express nominal exchange rate between two currencies (e.g. the US $ and Indian Rupee) namely direct quote and indirect quote.

1. **A Direct quote or European Currency Quotation:** Direct Quote is the number of units of a local currency exchangeable for one unit of a foreign currency.

   For example, Rs. 66/US$ means that an amount of Rs 66 is needed to buy one US dollar or Rs. 66 will be received while selling one US dollar.

   In a direct quotation, the foreign currency is the base currency and the domestic currency is the counter currency.

2. **An Indirect quote or American Currency Quotation:** An indirect quote is the number of units of a foreign currency exchangeable for one unit of local currency. For example: $ 0.0151 per rupee.

   In an indirect quotation, the domestic currency is the base currency and the foreign currency is the counter currency.

Note: A quotation in the direct form can easily be converted into a quotation in indirect form and vice-versa by taking the reciprocal of the given rate.

SIMILAR QUESTION:

1. Distinguish between Direct quote and Indirect quote?

A. Refer above answer

Q.No.4. Define the term Cross rate. (A) (SM)

Cross rate: There may be two pairs of currencies with one currency being common between the two pairs. The rate between other than common currency is derived from the given rates of the two pairs is called 'cross rate'.

For instance, exchange rates may be given between a pair, X and Y and another pair, X and Z. The rate between Y and Z is derived from the given rates of the two pairs (X and Y, and, X and Z) and is called 'cross rate'.

SIMILAR QUESTION:

1. What do you understand by the term 'Cross rate'?

A. Refer above answer

Q.No.5. When one goes to exchange currency in the market, generally which rates prevails in the market? (B) (SM)

There are generally two rates namely selling rate and buying rate, for any currency when one goes to exchange it in the market.

1. If there is no difference between the buying and the selling rate, the rate is said to be 'unique' or 'unified'. But, in practice, it is rarely so.
2. Selling rate is generally higher than the buying rate for a currency. This is the commission of the money exchanger (dealer) to run its operations.

SIMILAR QUESTION:

1. Comment on buying rate and selling rate.

A. Refer above answer

Q.No.6. Define the term Exchange rate regime. Explain the two major types of Exchange rate regimes? (A) (SM)

Exchange rate regime: An exchange rate regime is the system by which a country manages its currency in respect to foreign currencies. It refers to the method by which the value of the domestic currency in terms of foreign currencies is determined.

There are two major types of exchange rate regimes at the extreme ends, namely:

1. Floating exchange rate regime (or) Flexible exchange rate, and

2. Fixed exchange rate regime (or) pegged exchanged rate,

1. Floating exchange rate regime: Under floating exchange rate regime the equilibrium value of the exchange rate of a country's currency is market-determined (i.e. the demand for and supply of currency relative to other currencies determine the exchange rate).

a) There is no predetermined target rate (i.e. exchange rates are likely to change at every moment in time depending on the changing demand for and supply of currency in the market).

b) There is no interference on the part of the government or the central bank of the country in the determination of exchange rate.

c) Any intervention by the central banks in the foreign exchange market (through purchases or sales of foreign currency in exchange for local currency) is intended for only moderating the rate of change and preventing undue fluctuations in the exchange rate, rather than for establishing a particular level for it.

d) In few countries like New Zealand, Sweden, the United States, the central banks almost never interfere to administer the exchange rates.

e) Nearly all advanced economies and some large emerging market economies follow floating exchange rate regimes.

2. Fixed exchange rate: Under Fixed Exchange Rate regime a country's Central Bank and/ or government announces or decrees what its currency will be worth in terms of either another country's currency or a basket of currencies or another measure of value, such as gold. (For e.g., a certain amount of rupees per dollar.)

a) When a government intervenes in the foreign exchange market so that the exchange rate of its currency is different from what the market would have produced, it is said to have established a "peg" for its currency.

b) In order to sustain a fixed exchange rate, it is not enough that a country pronounces a fixed parity; it must also make concentrated efforts to defend that parity by being willing to buy (or sell) foreign reserves whenever the market demand for foreign currency is lesser (or greater) than the supply of foreign currency.

c) In order to maintain the exchange rate at the predetermined level, the central bank intervenes in the foreign exchange market.

SIMILAR QUESTIONS:

1. Appraise different types of exchange rate regimes.

A. Refer above answer

2. What is an 'Exchange rate regime'?

A. Refer introduction

3. Which are the major types of Exchange rate regimes?

A. Refer 1st and 2nd point

4. How is exchange rate determined under floating exchange rate regime? (RTP M19)

A. Refer 1st point

5. Define fixed exchange rate?

A. Refer 2nd point

6. Distinguish between fixed exchange rate and floating exchange rate? (M18 - 2M)

A. Refer above answer

7. Describe how exchange rate is determined under different exchange rate regimes?

A. Refer above answer

Q.No.7. What are the main advantages of a fixed exchange rate regime in an open economy? (A) (SM)(MTP-M19)

Fixed exchange rate: Under Fixed Exchange Rate regime a country's Central Bank and/ or government announces or decrees what its currency will be worth in terms of either another country's currency or a basket of currencies or another measure of value, such as gold. (For e.g., a certain amount of rupees per dollar.)

In an open economy, the main advantages of a fixed exchange rate regime are:

1. Fixed exchange rates avoids currency fluctuations and eliminates exchange rate risks and transactions costs and thus greatly enhance international trade and investment.
2. A fixed exchange rate system imposes discipline on a country's monetary authority and therefore is more likely to generate lower levels of inflation. With this stability the government can encourage greater trade and investment.
3. Exchange rate peg can also enhance the credibility of the country's monetary- policy
4. In the fixed or managed floating exchange rate regimes, the central bank is required to stand ready to intervene in the foreign exchange market to maintain an adequate amount of foreign exchange reserves for this purpose.

Conclusion: In short, a fixed rate brings in more currency and monetary stability and credibility; but it lacks flexibility.

SIMILAR QUESTION:

1. Evaluate the merits of fixed exchange rate regime?

A. Refer above answer

Q.No.8. What are the advantages and disadvantages of a Floating exchange rate regime in an economy? (A) (SM)

Floating exchange rate regime: Under floating exchange rate regime the equilibrium value of the exchange rate of a country's currency is market-determined.

The free floating or flexible exchange rate regime is argued to be efficient and highly transparent as the exchange rate is free to fluctuate in response to the supply of and demand for foreign exchange in the market and clears the imbalances in the foreign exchange market without any control of the monetary authority.

1. **A floating exchange rate has many advantages:**
   a) A floating exchange rate has the great advantage of allowing a Central bank and /or government to pursue its own independent monetary policy.
   b) Floating exchange rate regime allows exchange rate to be used as a policy tool: for example, policy-makers can adjust the nominal exchange rate to influence the competitiveness of the tradable goods sector
   c) As there is no obligation or necessity to intervene in the currency markets, the central bank is not required to maintain a huge foreign exchange reserves.

2. **Disadvantages of floating or flexible exchange rate regime:** This volatile exchange rate generate
   a) A lot of uncertainties in relation to international transactions,
   b) Add a risk premium to the costs of goods and assets traded across borders.

Conclusion: In short, a floating rate has greater policy flexibility; but less stability.

SIMILAR QUESTIONS:

1. **Mention the main demerit of floating exchange rate?**

A. Refer 2nd point

2. **Evaluate the relative merits and demerits of floating exchange rate regime?**

A. Refer above answer

Q.No.9. Define the terms Peg, Soft Peg and Hard Peg. (A) (SM)

1. **Peg:** When a government intervenes in the foreign exchange market so that the exchange rate of its currency is different from what the market would have produced, it is said to have established a "peg" for its currency.
2. **Soft Peg:** A soft peg refers to an exchange rate policy under which the exchange rate is generally determined by the market, but if the exchange rate tends to be move speedily in one direction, the central bank will intervene in the market.
3. **Hard Peg:** With a hard peg exchange rate policy, the central bank sets a fixed and unchanging value for the exchange rate.

SIMILAR QUESTION:

1. **Differentiate Soft peg and Hard peg.**

A. Refer 2nd and 3rd points.

Q.No.10. Comment on commonly adopted Exchange Rate System in the world. (B) (SM)

1. It is often misled to think that it is common for countries to adopt the flexible exchange rate system.
2. In the real world, there is a spectrum of 'intermediate exchange rate regimes' which are either inflexible or have varying degrees of flexibility that lie in between these two extremes (fixed and flexible). For example, a central bank can implement soft peg and hard peg policies.
3. Both soft peg and hard peg policy require that the central bank intervene in the foreign exchange market.

Q.No.11. Define the terms Nominal Exchange Rate, Real Exchange Rate and Real Effective Exchange Rate. (A) (MTP1 M18 - 2M)(SM)

1. **Nominal Exchange Rate**: It describes how much of one currency (i.e. money) can be traded for a unit of another currency when prices are constant.
2. **Real Exchange Rate (RER):** It describes 'how many' of a good or service in one country can be traded for 'one' of that good or service in a foreign country.

   When prices of goods and services change in either or both countries, it would be difficult to know the change in relative prices of foreign goods and services. Thus RER incorporates changes in prices is a better measure. It is calculated as:

$$\text{Real exchange rate} = \text{Nominal exchange rate} \times \frac{\text{Domestic Price Index}}{\text{Foreign Price Index}}$$

3. **Real Effective Exchange Rate (REER):** It is the nominal effective exchange rate (a measure of the value of a domestic currency against a weighted average of various foreign currencies) divided by a price deflator or index of costs.

   An increase in REER implies that exports become more expensive and imports become cheaper and indicates a loss in trade competitiveness.

SIMILAR QUESTIONS:

1. Explain the term 'Nominal exchange rate'.

A. Refer 1st point

2. Explain the term 'Real exchange rate'. (MTP1 N18 - 2M,MTP1 M18 - 2M)

A. Refer 2nd point

3. Explain the term 'Real effective exchange rate'. (MTP2 M18 - 2M)

A. Refer 3rd point

Q.No.12. Define the term Foreign Exchange Market. Also explain its features? (B) (SM)

Foreign Exchange Market: The wide-reaching collection of markets and institutions that handle the exchange of foreign currencies is known as the foreign exchange market. In this market, the participants use one currency to purchase another currency.

Features of Foreign Exchange Market:

1. It operates worldwide and is the largest market in the world in terms of cash value traded.
2. Being an over-the-counter market, it is not a physical place; rather, it is an electronically linked network of big banks, dealers and foreign exchange brokers who bring buyers and sellers together.
3. With no central trading location and no set hours of trading, the foreign exchange market involves enormous volume of foreign exchange trading worldwide.
4. The participants such as firms, households, and investors who demand and supply currencies represent themselves through their banks and key foreign exchange dealers who respond to market signals transmitted instantly across the world.
5. The foreign exchange markets operate on very narrow spreads between buying and selling prices.
6. Since the volumes traded are very large, the traders in foreign exchange markets stand to make huge profits or losses.

SIMILAR QUESTIONS:

1. Describe the chief characteristics of foreign exchange market?

A. Refer above answer

2. Describe the functioning of the foreign exchange market?

A. Refer above answer

Q.No.13. Explain the role of major participants in the exchange market? (B) (SM)

Foreign Exchange Market: The wide-reaching collection of markets and institutions that handle the exchange of foreign currencies is known as the foreign exchange market. In this market, the participants use one currency to purchase another currency.

The Role of major participants in the exchange market are as follows:

1. **Central Banks:** The central banks participate in the foreign exchange markets, not to make profit, but essentially to contain the volatility of exchange rate to avoid sudden and large appreciation or depreciation of domestic currency and to maintain stability in exchange rate in keeping with the requirements of national economy.

2. **Commercial Banks:** Commercial banks participate in the foreign exchange market either on their own account or for their clients. When they trade on their own account, banks may operate either as speculators or arbitrageurs/or both. The bulk of currency transactions occur in the interbank market in which the banks trade with each other.
3. **Government:** Government regulate the exchange rates indirectly.
4. **Multinational corporations:** They engage in international trade and investments.
5. **Non-bank financial institutions such as asset- management firms, insurance companies, brokers, arbitrageurs and speculators:**
   a) Foreign exchange brokers participate in the market as intermediaries between different dealers or banks.
   b) Arbitrageurs profit by discovering price differences between pairs of currencies with different dealers or banks.
   c) Speculators, who are bulls or bears, are deliberate risk-takers who participate in the market to make gains which result from unanticipated changes in exchange rates.
6. **Individuals:** They form only a very insignificant fraction in terms of volume and value of transactions.
7. **Foreign Exchange Dealers.**

SIMILAR QUESTIONS:

1. **Who are the participants in the foreign exchange market? Explain their role of participation.**

A. Refer above answer

2. **What are the different roles played by the participants in the foreign exchange market?**

A. Refer above answer

3. **What is meant by foreign exchange market? What are the roles played by the participants in the foreign exchange market? (MTP-N19)**

A. Refer above answer

Q.No.14. What is meant by Arbitrage? Explain its potentiality and applicability in forex market? (A) (MTP1 N18 - 2M)(SM)

Arbitrage: Arbitrage refers to the practice of making risk-less profits by intelligently exploiting price differences of an asset at different dealing locations.

Potentiality and applicability of Arbitrage in forex market:

1. There is potential for arbitrage in the forex market if exchange rates are not consistent between currencies.
2. When price differences occur in different markets, participants purchase foreign exchange in a low-priced market for resale in a high-priced market and makes profit in this process.
3. Due to the operation of price mechanism, the price is driven up in the low- priced market and pushed down in the high-priced market. This activity will continue until the prices in the two markets are equalized, or until they differ only by the amount of transaction costs involved in the operation.
4. Since forex markets are efficient, any profit spread on a given currency is quickly arbitraged away.
5. Regardless of physical location, and when the markets are highly integrated, at any given moment, all markets tend to have the same exchange rate for a given currency. This phenomenon occurs because of arbitrage.

SIMILAR QUESTION:

1. **What is Arbitrage? What is the outcome of Arbitrage?**

A. Refer above answer

Q.No.15. Explain the two types of transactions involved in Forex market and also compare those two exchange rates? (A) (SM)

Foreign Exchange Market: The wide-reaching collection of markets and institutions that handle the exchange of foreign currencies is known as the foreign exchange market. In this market, the participants use one currency to purchase another currency.

In the foreign exchange market, there are two types of transactions:

1. **Spot (or) Current transactions:**
   a) These are carried out in the spot market and the exchange involves immediate delivery.
   b) Exchange rates prevailing for spot trading (for which settlement by and large takes two days) are called spot exchange rates.
2. **Forward transactions:**
   a) Contracts to buy or sell currencies for future delivery are carried out in forward and/or futures markets.
   b) The exchange rates quoted in foreign exchange transactions that specify a future date are called forward exchange rates.
   c) For example, when a party agrees to sell euro for dollars on a future date at a forward rate agreed upon, he has 'sold euros forward' and 'bought dollars forward'.
   d) Currency futures, though conceptually similar to currency forward and perform the same function, they are distinct in their nature and details concerning settlement and delivery.

In comparison with spot exchange rates and forward exchange rates:

a) The currency forward contracts are quoted just like spot rate; however, the actual delivery of currencies takes place at the specified time in future.

b) A forward premium is said to occur when the forward exchange rate is more than a spot trade rates.

c) If the forward trade is quoted at a lower rate than the spot trade, then there is a forward discount.

SIMILAR QUESTION:

1. **Mention the types of transactions in the forex market? (MTP N18 - 2M)**

A. Refer 1st and 2nd point

Q.No.16. Why the dollar is often called a 'vehicle currency'. (B) (SM)

Dollar as a 'vehicle currency': While a foreign exchange transaction can involve any two currencies, most transactions involve exchanges of foreign currencies for the U.S. dollars even when it is not the national currency of either the importer or the exporter. On account of its critical role in the forex markets, the dollar is often called a 'vehicle currency'.

Q.No.17. How the Nominal exchange rate is determined? Also explain it graphically. (A) (SM)

Nominal exchange rate: Usually, the supply of and demand for foreign exchange in the domestic foreign exchange market determine the external value of the domestic currency, i.e. a country's exchange rate.

a) **On the demand side, people desire foreign currency to:**
   i) Purchase goods and services from another country
   ii) For unilateral transfers such as gifts, awards, grants, donations or endowments

iii) To make investment income payments abroad

iv) To purchase financial assets, stocks or bonds abroad

v) To open a foreign bank account

vi) To acquire direct ownership of real capital

vii) For speculation and hedging activities related to risk-taking or risk-avoidance activity

b) **The supply of foreign currency to the home country results from**:

i) Purchases of home exports

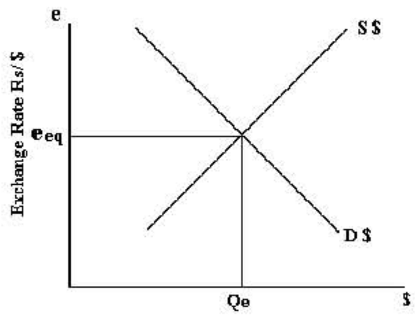
ii) Unilateral transfers to home country

iii) Investment income payments

iv) Foreign direct investments and portfolio investments

v) Placement of bank deposits and speculation.

c) **Determination of Nominal Exchange Rate:** Similar to any standard market, the exchange market also faces a downward-sloping demand curve and an upward-sloping supply curve.



From the graph:

1. The equilibrium rate of exchange is determined by the interaction of the supply and demand for a particular foreign currency say dollars.
2. The demand curve (D$) and supply curve (S$) of dollars intersect to determine equilibrium exchange rate e_{eq} with Q_e as the equilibrium quantity of dollars exchanged.

SIMILAR QUESTIONS:

1. How the Nominal exchange rate is determined from the demand side?

A. Refer a) point

2. How the Nominal exchange rate is determined from the Supply side?

A. Refer b) point

3. *Using suitable diagram, explain, how the nominal exchange rate between two countries is determined'? (M19-3M)*

A. Refer the above Answer

Q.No.18. Do changes take place in exchange rates? If so elucidate them with an example. (B) (SM, RTP M18)

Changes in Exchange Rates: Changes in exchange rates represent depreciation or appreciation of one currency. The terms, Rupee 'currency appreciation' and 'currency depreciation' describe the movements of the exchange rate.

1. Currency appreciates when its value increases with respect to the value of another currency or a basket of other currencies.

2. Currency depreciates when its value falls with respect to the value of another currency or a basket of other currencies.

3. When one currency depreciates against another, the second currency must simultaneously appreciate against the first.

Example:

If the Rupee dollar exchange rate in the month of January is $1 = Rs. 65 and in the month of April it is $1 = Rs. 70.

In April, exchange will be with a greater amount of Indian Rupees (Rs.70) to get the same 1 US dollar. Thus Indian Rupee has depreciated in its value. (Rupee depreciation means that the rupee has become less valuable with respect to the U.S. dollar)

If the value of dollar is taken in terms of Rupees, then one dollar will now fetch Rs. 70 instead of Rs. 65 earlier. This is called appreciation of the US dollar. (The value of the US dollar has increased in terms of the Indian Rupee).

SIMILAR QUESTION:

1. What do you understand by appreciation and depreciation of currency?

A. Refer 1st and 2nd point

Q.No.19. Explain Home-currency depreciation under Floating Exchange Rates graphically? (A) (SM)

Home-currency depreciation (or) Foreign-currency appreciation:

It takes place when there is an increase in the home currency price of the foreign currency (or, alternatively, a decrease in the foreign currency price of the home currency). The home currency thus becomes relatively less valuable.

Home-currency depreciation under Floating exchange rates:

Under a floating rate system the demand curve for foreign currency shifts to the right (increase in demand) and the supply curve remain unchanged, there will be rise in the exchange value of foreign currency and it depreciates the domestic currency value.

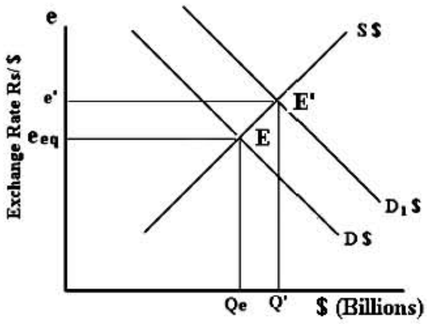
From the graph:

i) The market reaches equilibrium at point E with equilibrium exchange rate e_{eq}

ii) An increase in domestic demand for the foreign currency, with supply of dollars remaining constant, is represented by a rightward shift of the demand curve to $D_1\$$.

iii) The equilibrium exchange rate rises to e^1.

iv) It means that more units of domestic currency (Indian Rupees) are required to buy a unit of foreign exchange (dollar) and that the domestic currency (the Rupee) has depreciated.



SIMILAR QUESTION:

1. Explain foreign-currency appreciation under Floating Exchange Rates graphically?

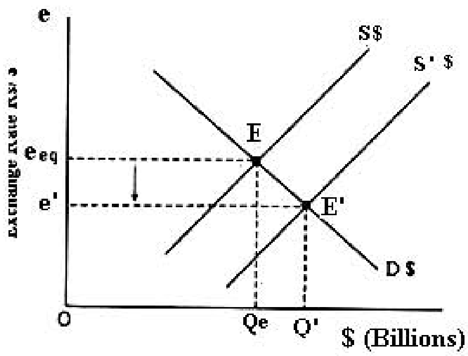
A. Refer above answer

Q.No.20. Explain Home-currency Appreciation under Floating Exchange Rates graphically? (A) (SM)

1. **Home-currency appreciation or foreign-currency depreciation:** It takes place when there is a decrease in the home currency price of foreign currency (or alternatively, an increase in the foreign currency price of home currency). The home currency thus becomes relatively more valuable.

2. **Home-currency appreciation under Floating Exchange Rates:** Under a floating rate system when the supply curve of foreign currency shifts to the right and the demand curve remains unchanged, there will be an increase in the supply of dollars in the Indian market.

From the graph:



i) An increase in the supply of foreign exchange shifts the supply curve to the right to S^1 $ and as a consequence, the exchange rate declines to E^1.

ii) It means, that lesser units of domestic currency (Indian Rupees) are required to buy a unit of foreign exchange (dollar), and that the domestic currency (the Rupee) has appreciated.

SIMILAR QUESTIONS:

1. **Describe the term home currency appreciation?**

A. **Refer 1st point**

2. **Explain foreign-currency depreciation under Floating Exchange Rates graphically?**

A. **Refer 2nd point**

Q.No.21. Distinguish between Devaluation and Depreciation. (B) (MTP2 N18 -2M) (SM)

DEVALUATION vs. DEPRECIATION:

Devaluation: Devaluation is a deliberate downward adjustment in the value of a country's currency relative to another currency, group of currencies or standard.

i) It is a monetary policy tool used by countries that have a fixed exchange rate or nearly fixed exchange rate regime and involves a discrete official reduction in the otherwise fixed par value of a currency.

ii) The monetary authority formally sets a new fixed rate with respect to a foreign reference currency or currency basket.

Depreciation: Depreciation is a decrease in a currency's value (relative to other major currency benchmarks) due to market forces under a floating exchange rate and not due to any government or central bank policy actions.

Q.No.22. Distinguish between Revaluation and Appreciation. (B) (SM)

REVALUATION vs. APPRECIATION:

Revaluation: Revaluation is the opposite of devaluation and the term refers to a discrete raising of the otherwise fixed par value of a nation's currency.

Appreciation: Appreciation is an increase in a currency's value (relative to other major currencies) due to market forces under a floating exchange rate and not due to any government or central bank policy interventions.

Q.No.23. Explain the impacts of exchange rate fluctuations in terms of currency depreciation on domestic economy? (A) (SM, MTP M18) (Self Study)

Exchange Rate Fluctuations: As a matter of fact exchange rate fluctuations may determine a country's economic performance. Knowledge about these possible enables to understand the appropriateness of exchange rate policy, especially in developing countries.

Impacts of currency depreciation on domestic economy:

The developments in the foreign exchange markets affect the domestic economy both directly and indirectly.

The direct impact of fluctuations in rates is initially felt by economic agents who are directly involved in international trade or international finance. It becomes necessary to evaluate their effects on trade, investments, consumption output, economic growth and inflation.

1. **Impact on trade:** Changes in import and export prices will lead to changes in import and export volumes, causing changes in import spending and export revenue.
2. **Impact by changing the relative prices of domestically-produced and foreign-produced goods and services:**
   a) An appreciation of a country's currency raises the relative price of its exports and lowers the relative price of its imports. (Foreigners pay more for the country's products and domestic consumers pay less for foreign products).
   b) The depreciation lowers the relative price of a country's exports and raises the relative price of its imports. (For foreigners exports become cheaper and for domestic residents imports become more expensive.)
   c) By changing the relative prices, depreciation may increase windfall profits in export and import-competing industries.
   d) Depreciation may also cause contractionary effects. (In an under developed or semi industrialized country, where - inputs (such as oil) and components for manufacturing are mostly imported and cannot be domestically produced, increased import prices will increase firms' cost of production , push domestic prices up and decrease real output.)
3. **Impact on economic activity in the domestic economy:**
   a) A depreciation of domestic currency increases the price of foreign goods relative to goods produced in the home country and diverts spending from foreign goods to domestic goods.
   b) Increased demand, both for domestic import-competing goods and for exports encourages economic activity and creates output expansion (i.e. an expansionary impact on the economy at an aggregate level).
4. **Impact on real income:**
   a) By lowering export prices, currency depreciation helps to increase the international competitiveness of domestic industries, increases the volume of exports and promotes trade balance.
   b) Often the price changes in exports and imports may counterbalance or offset each other only if trade is in balance and terms of trade are not changed.
   c) In case the country's imports exceed exports, the net result is a reduction in real income within the country.
5. **Impact on employment income and potentially on wages:**
   a) For an economy where exports are high, a depreciated currency would mean a lot of gain.
   b) If exports originate from labour-intensive industries, increased export prices will have positive effect employment income and potentially on wages.
6. **Impact on Inflation:**
   a) Depreciation adds to consumer price inflation in the short run, directly through its effect on prices of imported consumer goods and also due to increased demand for domestic goods.
   b) The impact will be greater if the composition of domestic consumption baskets consists more of imported goods.
   c) Indirectly, cost push inflation may result through possible escalation in the cost of imported inputs.
   d) In such an inflationary situation, the central bank of the country will have no incentive to cut policy rates as this is likely to increase the burden of all types of borrowers including businesses.
7. **Impact on Factors of production:**
   a) When a country's currency depreciates, production for exports and of import substitutes become more profitable.
   b) Therefore, factors of production will be induced to move into the tradable goods sectors and out of the non-tradable goods sectors.

c) The reverse will be true when the currency appreciates.

d) These types of resource movements involve economic wastes.

8. **Impact on terms of trade:**

a) Terms of trade is the ratio of the price of a country's export commodity to the price of its import commodity

b) Since the prices of both exports and imports rise in terms of the domestic currency as a result of depreciation or devaluation, the terms of trade of the nation can rise , fall or remain unchanged, depending on whether price of exports rises by more than, less than or same percentages as price of imports.

9. **Impact on Current account:**

a) The fiscal health of a country whose currency depreciates will be affected with rising export earnings and import payments and consequent impact on current account balance.

b) A widening current account deficit is a danger signal as far as growth prospects of the overall economy is concerned.

c) If export earnings rise faster than the imports spending then current account will improve otherwise not.

10. **Impact on Companies borrowed in foreign exchange through external commercial borrowings (ECBs):**

a) ECBs being careless and did not sufficiently hedge these loans against foreign exchange risks would also be negatively impacted as they would require more domestic currency to repay their loans.

b) A depreciated domestic currency would increase their debt burden and lower their profits and impact their balance sheets adversely.

c) These would signal investors who will be discouraged from investing in such companies.

11. **Impact on public debt:**

a) Countries with foreign currency denominated government debts, currency depreciation will increase the interest burden and cause strain to the exchequer for repaying and servicing foreign debt.

b) Fortunately, India's has small proportion of public debt in foreign currency.

12. **Impact on financial forecasting:** Exchange rate fluctuations make financial forecasting more difficult for firms and larger amounts will have to be earmarked for insuring against exchange rate risks through hedging.

13. **Impact on international investments:**

a) Investors who have purchased a foreign asset, or the corporation which floats a foreign debt, will find themselves facing foreign exchange risk.

b) Exchange rate movements have become the single most important factor affecting the value of investments on an international level.

c) They are critical to business volumes, profit forecasts, investment plans and investment outcomes.

d) Depreciating currency hits investor sentiments and has radical impact on patterns of international capital flows.

14. **Impact on foreign portfolio investment (FPI) and foreign direct investment (FDI):**

a) FPI flows into debt and equity and thus FDI flows are likely to shrink. **(M19 - 3M)**

b) This shoots up capital account deficits affecting the country's fiscal health.

c) If investor anticipate further depreciation, there may be large scale withdrawal of FPI and huge redemptions (*through global exchange traded funds*) leading to further depreciation of domestic currency.

d) This may result in a highly volatile domestic equity market affecting the confidence of domestic investors.

e) Reduced foreign investments also widen the gap between investments required for growth and actual investments.

f) Over a period of time, unemployment is likely to mount in the economy.

15. The other impacts of currency depreciation are:

a) With increasing dependence on imports, it leads to higher international prices of fuel impacting domestic transportation and overall cost of production triggered inflation, increase in oil and fertilizer subsidy bills, costly foreign travel, escalated foreign debt service payments and higher outstanding ECBs and government's foreign debt.

b) Windfall gains for export oriented sectors (such as IT sector, textile, pharmaceuticals, gems and jewelry in the case of India) because depreciating currency fetches more domestic currency per unit of foreign currency.

c) Remittances to homeland by non-residents and businesses abroad fetches more in terms of domestic currency.

d) Depreciation would enhance government revenues from import related taxes, especially if the country imports more of essential goods.

e) Depreciation would result in higher amount of local currency for a given amount of foreign currency borrowings of government.

f) Depreciation have a positive impact on country's trade deficit as it makes imports more expensive for domestic consumers and exports cheaper for foreigners.

g) Depreciation have a positive impact on controlling spiraling gold imports (mostly wasteful) and thereby improve trade balance.

SIMILAR QUESTIONS:

1. Explain changes in exchange rates and their impact on the real economy.

A. Refer above answer

2. Explain the effects of currency depreciation? Do you consider a weak currency is advantageous to a country?

A. Refer above answer

3. 'Flexible exchange rates reflect the true fiscal health of the economy' Elucidate.

A. Refer 9th and 14th points

4. Explain the nature of changes in exchange rates and their impact on real economy?

A. Refer points 1,3,5,7 & 8.

Q.No.24. Explain the impacts of exchange rate fluctuations in terms of appreciation of currency on domestic economy? (A) (SM) (Self Study)

Appreciation of currency: An appreciation of currency or a strong currency (or) an overvalued currency) makes the domestic currency more valuable and, therefore, can be exchanged for a larger amount of foreign currency.

Impacts of currency depreciation on domestic economy:

1. Impact on Economic growth:

a) An appreciation of currency raises the price of exports and, exports would fall. Since imports become cheaper, and thus imports rises.

b) Thus the domestic aggregate demand falls and economic growth is negatively impacted.

2. Impact on Business cycle:

a) If appreciation sets in during the recessionary phase, this causes fall in aggregate demand and higher levels of unemployment.

b) If the economy is facing a boom, an appreciation of domestic currency would trim down inflationary pressures and soften the rate of growth of the economy.

3. **Impact on Inflation:**

a) An appreciation may cause reduction in inflation because imports are cheaper.

b) Lower price of imported capital goods, components and raw materials leads to decrease in cost of production which leads to fall in prices.

c) Decrease in aggregate demand tends to lower demand pull inflation.

d) Living standards of people are likely to improve due to availability of cheaper consumer goods.

4. **Impact on technological innovations and capital intensive production:**

a) With increasing export prices, the competitiveness of domestic industry is adversely affected.

b) Thus the firms have greater incentives to introduce technological innovations and capital intensive production to cut costs to remain competitive.

5. **Impact on Current account:**

a) Increasing imports and declining exports are liable to cause larger deficits and worsen the current account.

b) The impact of appreciation on current account depends upon the elasticity of demand for exports and imports.

c) Relatively inelastic demand for imports and exports leads to an improvement in the current account position.

d) Higher the price elasticity of demand for exports, greater would be the fall in demand and higher will be the fall in the aggregate value of exports. This will adversely affect the current account balance.

6. **Impact on competitiveness:** Loss of competitiveness will be insignificant if currency appreciation is because of strong fundamentals of the economy.

SIMILAR QUESTION:

1. 'An overvalued currency is a bane for an economy'. Do you agree with the statement? Give examples.

A. Refer above answer

QUESTIONS FOR ACADEMIC INTEREST - FOR STUDENT SELF STUDY

Q.No.25. Why exchange rate movements can affect intentional trade flows? (C) (SM)

In an open economy, firms and households use exchange rates to translate foreign prices into domestic currency terms. Exchange rates also permit us to compare the prices of goods and services produced in different countries. Furthermore, import or export prices could be expressed in terms of the same currency in the trading contract. This is the reason why exchange rate movements can affect intentional trade flows.

Q.No.26. Define Fixed or Managed floating exchange rate regimes? (C) (SM)

Fixed or Managed floating exchange rate regimes is where the market forces are allowed to determine the exchange rate within a band

Q.No.27. What happens If the domestic currency fluctuates excessively? (C) (SM)

If the domestic currency fluctuates excessively, it causes panic and uncertainty in the business world.

Q.No.28. Assume that there is devaluation or depreciation of Indian Rupee from $1 = Rs.65/ to $1 = Rs.70/.Who will be benefited either resident of India or foreigners? (C) (SM)

A foreigner who spends ten dollars on buying Indian goods will, post devaluation, get goods worth Rs.700/ instead of Rs 650/ prior to depreciation. An importer has to pay for his purchases in foreign currency, and, therefore, a resident of India, who wants to import goods worth $1 will have to pay Rs 70/ instead of Rs 65/ prior to depreciation. Importers will be affected most as they will have to pay more rupees on importing products. On the contrary, exporters will be benefitted as goods exported abroad will fetch dollars which can now be converted to more rupees.

Q.No.29. On what factors do the positive effect of currency depreciation depends upon? (C) (SM)

The positive effect of currency depreciation depends on

i) Whether the switching of demand has taken place in the right direction and in the right amount,

ii) The capacity of the home economy to meet the additional demand by supplying more goods to meet the increased domestic demand.

Q.No.30. Do all the countries would desire to have fluctuations or stability in exchange rates? (C) (SM)

i) All countries would desire to have steady exchange rates to eliminate the risks and uncertainties associated with international trade and investments.

ii) Nations may sometimes go in for tradeoffs with weaker exchange rate to stimulate exports and aggregate demand, or a stronger exchange rate to fight inflation.

Q.No.31. What are the major merits of floating exchange rate? (C) (SM)

A floating exchange rate allows a government to pursue its own independent monetary policy and there is no need of market intervention or maintenance of reserves.

Exchange rate regimes	Description
Exchange arrangements with no separate legal tender (**Dollarization**)	Currency of another country circulates as sole legal tender or member belongs to a monetary or currency union in which same legal tender is shared by members of the union.
Currency Board arrangements (**Hong Kong dollar**)	Monetary regime based on implicit national commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate.
Other conventional fixed peg arrangement (**Chinese Yuan**)	Country pegs its currency (formal or de facto) at a fixed rate to a major currency or a basket of currencies where exchange rate fluctuates within a narrow margin or at most ±1% around central rate
Pegged exchange rates within horizontal bands	Value of the currency is maintained within margins of fluctuations around a formal or de facto fixed peg that are wider than ± 1% around central rate.
Crawling Peg	Currency is adjusted periodically in small amounts at a fixed, preannounced rate in response to changes in certain quantitative indicators.
Crawling bands	Currency is maintained within certain fluctuation margins say (± 1-2 %) around a central rate that is adjusted periodically.
Managed floating within no preannounced path for exchange rate. **(Indian Rupee)**	Monetary authority influences the movements of the exchange rate through active intervention in foreign exchange markets without specifying a pre-announced path for the exchange rate.

Independent floating **(US Dollar, Japanese Yen, New Zealand Dollar)**	Exchange rate is market determined, with any foreign exchange intervention aimed at <u>moderating the rate of change</u> and preventing undue fluctuations in the exchange rate, rather than at establishing a level for it.

Q.No.32. State the IMF Classifications, definitions and Distribution of prevalent Exchange rate systems. (B) (SM)

IMF Classifications and Definitions of Exchange Rate Regimes as on April 30, 2016 on the distribution of the 189 IMF members based on their exchange rate regimes.

<u>Distribution of IMF Members Based on Exchange Regime:</u>

Exchange rate Arrangement	% of IMF Members
Hard peg	13.0
No separate legal tender	7.3
Currency board	5.7
Soft Peg	39.6
Conventional Peg	22.9
Stabilized arrangement	9.4
Crawling Peg	1.6
Crawl-like arrangement	5.2
Pegged exchange rate within horizontal bands	0.5
Floating	37.0
Floating	20.8
Free Floating	16.1
Other managed arrangements	10.4

Source: Annual Report on Exchange Arrangements and Exchange Restrictions, IMF

DIFFERENCES

Q.No.33. Differentiate exchange rate regimes (B) (SM)

	Soft peg	Hard peg	Float
Meaning	A soft peg refers to an exchange rate policy under which the exchange rate is generally determined by the market, but if the exchange rate tends to be move speedily in one direction, the central bank will intervene in the market.	With a hard peg exchange rate policy, the central bank sets a fixed and unchanging value for the exchange rate.	It is a regime where the currency price is set by the forex market based on supply and demand compared with other currencies.
Regimes	crawling narrow band, crawling peg, pegged within bands, crawling broad bands and fixed peg crawling narrow band, crawling peg, pegged within bands, crawling broad bands and fixed peg	Currency Board and Currency Union Dollarization	Independent float; Light managed float and Managed Float
Exchange Rate Volatility	Medium	Low	High

Q.No.34. Depreciation Vs. Devaluation (A) (SM)

	Depreciation	Devaluation
a) Meaning	Depreciation is a decrease in a currency's value (relative to another currency) due to **market forces** in a Floating Exchange Rate Regime	Devaluation is a **deliberate downward adjustment** in the value of a Country's Currency relative to another currency, group of currencies or standard
b) Cause	Depreciation is caused due to increase in Demand, with Supply remaining constant.	Devaluation is caused by the action of the Government / Central Bank/ Monetary Authority policy actions.
c) Regime	Applicable for a Floating Exchange Rate Regime	Applicable for a relative Fixed Exchange Rate Regime
d) Scope	It is due to the interaction of market forces.	It is a monetary policy tool to make an official reduction in the par value of a currency

Note: The terms "**Appreciation**" and "**Revaluation**" are used to denote the opposite of the above two terms "Depreciation" and "Devaluation" respectively.

Q.No.35. Effect of Exchange Rate Fluctuations (B) (SM)

	Home currency Depreciation	Home Currency Appreciation
Exports	Depreciation lowers the relative price of a Country's exports. Foreigners find that the country's exports are cheaper, and Export Demand increases.	Depreciation increases the relative price of a Country's exports. Foreigners pay more for the country's products, Export Demand decreases.
Imports	Domestic Residents and Importers have to pay more Home Currency on importing products. Demand for Imports decreases.	Domestic Consumers pay less for foreign products. The demand for Imports increases.
Domestic Inflation	If Imported Goods are a significant portion of the domestic consumption, there will be Inflation. If Imported Inputs are used in production of Final Goods, there will be Cost Push Inflation.	If Imported Goods are a significant portion of the domestic consumption, there will be reduction in Inflation levels.

Q.No.36. Direct vs. Indirect Quote (B) (SM)

Point	Direct Quote	Indirect Quote
Meaning	A Direct Quote is the number of units of a Local Currency exchangeable for one unit of a Foreign Currency	An Indirect Quote is the number of units of a Foreign Currency exchangeable for one unit of a Local Currency
Example	Rs. 72/ US $ means Rs. 72 is required to buy 1 US $.	$ 0.0139 per Rupee means Rs. 1 is obtained by selling $ 0.0139
Base Currency	Local Currency (i.e. Rupee in the above case)	Foreign Currency (i.e. US $ in the above case)
Counter Currency	Foreign Currency (i.e. US $ in the above case)	Local Currency (i.e. Rupee in the above case)
Also called	**European** Currency Quotation	**American** Currency Quotation

TEST YOUR KNOWLEDGE

1. Do the central bank intervene in the foreign exchange market is required for both soft peg and hard peg policy?
2. Explain 'depreciation' and 'appreciation' of home currency under floating exchange rate. **(M19-2M)**
3. Explain the implications of the following on the demand and supply of foreign exchange and the exchange rate in spot foreign exchange market.
   - **i)** Sherry Land's exports remained more or less stagnant in the years 2005 - 06 to 2016 - 17. However, due to heavy thrust on industrialization, import of machinery, raw materials and components as well as associated services of different types increased.
   - **ii)** The investors of Merry Land find investments in financial assets in UK highly attractive and the government of Merry Land which has a liberal attitude on foreign investments permits such investments.
   - **iii)** Many foreign investors who had previously acquired Roseland's financial assets sell them
   - **iv)** Effect on Country Y if Country X borrows $ 100 billion from country Y
4. Explain how the exchange value of Indian Rupee will be affected in each of the following cases. What are the possible consequences on exports and imports?
   - **i)** The spot exchange rate changes from Rs 61/ 1$ to Rs 64/1$
   - **ii)** The spot exchange rate changes from Rs 66/ 1$ to Rs 63/1$
5. In 1983 Australia decided to float its dollar. Assuming free trade, explain the effects of each of the following on the spot exchange rate between AUD and USD.
   - **i)** There is a substantial increase demand in Australia for US exports of services. Since Australia manufactures were favoured over others, there is a proportionate increase in exports of Australian products to the US
   - **ii)** Investors in Australia perceive that the returns on investments in the US would be much more lucrative than elsewhere. As a result there is a huge increase in demand for investments in US dollar denominated financial investments
   - **iii)** Political uncertainties in the US due to presidential elections caused large scale shift of Australian financial investments back into Australia
   - **iv)** An epidemic in some parts of Australia made the US evoke SPS measures and ban the entry of a number of food items to the US
6. Compare the two exchange regimes briefly.
   - **i)** Fixed rate brings in more currency and monetary stability and credibility; but it lacks flexibility.
   - **ii)** Floating rate has greater policy flexibility; but less stability.

LIST OF FORMULAE

1. Direct Quote = $\dfrac{1}{\text{Indirect Quote}}$

2. Indirect Quote = $\dfrac{1}{\text{Direct Quote}}$

3. Cross Rate = $\dfrac{\text{Exchange Rate of A}}{\text{Exchange Rate of B}} \times \dfrac{\text{Exchange Rate of B}}{\text{Exchange Rate of C}}$

4. Real Exchange Rate = $\dfrac{\text{Nominal Exchange Rate x Domestic Price}}{\text{Foreign Price}}$

PROBLEMS FOR CLASSROOM DISCUSSION

1. Identify Whether the following quotes offered by a Kolkata Bank, are in direct or indirect format, and provide the corresponding indirect or direct quotes.

S.No.	Currency	Rate	Quote
a)	Rand (ZAR)	5.8781	Rupees per Rand
b)	Krona (SEK)	0.1040	Krona per Rupee
c)	Pound (GBP)	101.808	Rupees per pound
d)	Saudi Riyal (SAR)	0.0607	Riyal per Rupee

(ANS.: A) DIRECT, 0.1701 ZAR/INR, B) INDIRECT, 9.615 INR/SEK, C) DIRECT, 0.0098 GBP/INR, D) INDIRECT, 16.474 INR/SR)

(SOLVE PROBLEM NO. 1 OF ASSIGNMENT PROBLEMS AS REWORK)

2. For the following information you are required to specify the direct or indirect format of quote, and to convert the rates into the other format

S.No.	Place of Quote	Product	Price	Rate
a)	London	Sterling	Dollar	1.65189
b)	Tokyo	CHF	Yen	118
c)	Geneva	UAE Dirham	CHF	0.242
d)	Singapore	Malay Ringits (MYR)	SGD	0.38477

(ANS.: A) INDIRECT, 0.605 POUND/USD, B) DIRECT, 0.008 CHF/YEN, C) DIRECT, 4.132 AED/CHF, D) DIRECT, 2.599 MYR/SGD)

3. Consider the following and determine the cross rates, as indicated

i) INR/NOK = 10.14	ii) USD/AUD = 0.8925
INR/GBP = 101.80	INR/AUD = 55.00
NOK/GBP = ?	a) USD/INR & b) INR/USD = ?

(ANS.: I) 10.04; II) A) USD/INR = 0.016, B) INR/USD = 61.62)

(SOLVE PROBLEM NO. 2, 3, 4 OF ASSIGNMENT PROBLEMS AS REWORK)

4. The following rates appear in the foreign exchange market:

	Spot rate	2 months Forward
Rs./US $	Rs.45.80/46.05	Rs.46.50/47.00

a) How many dollars should a firm sell to get Rs. 5crores after 2 months?

(ANS.: RS. 1 = $ 0.0215, FOR RS. 5 CRORES = $ 10,75,000)

b) How many rupees is the firm required to pay obtain US$ 2,00,000 in the spot market?

(ANS.: RS. 92,10,000)

c) Assume the firm has US$ 50,000. How many rupees does the firm in exchange of US$?

(ANS.: RS. 22,90,000)

5. The Nominal Exchange rate of India is Rs. 56 / 1 $, Price Index in India is 116 and Price Index in USA is 112. What will be the Real Exchange Rate of India? *(N18 - 2M) (ANS.: 58)*

6. Assume that Rs.70 is needed to buy one US dollar in foreign exchange market (i.e. the nominal exchange rate is Rs.70/ US $). Suppose that a price index of standardized basket of goods and services is Rs.200 in India and US $ 100 in United States, find out the real exchange rate? (Treat India as a domestic country and United States as a foreign country)

(RTP N 19) (ANS: Real Exchange Rate = 140)

ASSIGNMENT PROBLEMS

1. UTI bank quotes Rs.26.45 for Australian dollar. Show what they would quote if it were an indirect quote. ***(ANS.: RS. 1 = AUD 0.0378)***

2. The following direct quotes have been observed from the forex market:

Rs. / $: 43.70

DM/$: 1.578(overseas)

Find cross rates for Rs. /DM ***(ANS.: RS. / DM = 27.6933)***

3. If the Euro INR is equal to INR 70.25 and Euro Bangladesh Taka (BTK) exchange rate is BTK 99.18. What is the cross rate INRBTK rate? ***(ANS.: 1.4118 INR FOR BTK)***

4. USD is worth Yen 125 and is equal to 1.6949 Fijian Dollar. What is the cross rate between Yen/Fijian Dollar (with yen as base currency)? ***(ANS.: 0.014)***

THE END