11. EXCHANGE RATE AND ITS ECONOMIC EFFECTS

ASSIGNMENT SOLUTIONS

PROBLEM NO: 1

Given, 1 AUS $ = Rs. 26.45 (Direct Quote)

Indirect Quote = $\frac{1}{\text{Direct Quote}} = \frac{1}{26.45}$ = 0.0378 AUS $ for Re. 1

PROBLEM NO: 2

Given, Rs. / $ = 43.70

DM / $ = 1.578

Rs. / DM = $\frac{\text{Rs.}}{\$} \times \frac{\$}{\text{DM}} = 43.70 \times \frac{1}{1.578}$ = 27.6933 Rs. / DM

PROBLEM NO: 3

Given,

$\frac{\text{Euro}}{\text{INR}} = 70.25$ (or) 1 Euro (€) = Rs. 70.25

$\frac{\text{Euro}}{\text{BTK}} = 99.18$ (or) 1 Euro (€) = BTK 99.18

To find,

$\frac{\text{INR}}{\text{BTK}} = \frac{\text{INR}}{\text{Euro}} \times \frac{\text{Euro}}{\text{BTK}}$

$= \frac{1}{70.25} \times 99.18$

$\frac{\text{INR}}{\text{BTK}} = 1.4118$ (or) 1INR = BTK 1.4118

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PROBLEM NO: 4

Given,

$\frac{\text{USD}}{\text{Yen}} = 125$ (or) 1 USD = Yen 125

$\frac{\text{USD}}{\text{Fijian Dollars}} = 1.6949$ (or) 1 USD = Fijian Dollars 1.6949

To find,

$\frac{\text{Yen}}{\text{Fijian Dollars}} = \frac{\text{Yen}}{\text{USD}} \times \frac{\text{USD}}{\text{Fijian Dollars}}$

$= \frac{1}{125} \times 1.6949$

$\frac{\text{Yen}}{\text{Fijian Dollars}} = 0.01355 = 0.014$ (or) 1Yen = 0.014 Fijian Dollars

ANSWERS FOR TEST YOUR KNOWLEDGE QUESTIONS

QUESTION NO. 1

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.

Hard Peg: With a hard peg exchange rate policy, the central bank sets a fixed and unchanging value for the exchange rate.

Intervention of central bank in the Forex market: In the hard peg the central bank sets a fixed and unchanging value for the exchange rate but whereas in the hard peg if the exchange rate tends to be move speedily in one direction, the central bank will intervene in the market.

QUESTION NO. 2

i) Higher demand in Sherry Land for foreign exchange (say $) to make development imports for industrialization; coupled with no proportionate increase in supply on account of meager inflow of foreign exchange consequent on stagnant exports for more than a decade, lead to rise in exchange rate and depreciation in the value of domestic currency.

ii) Increased demand for foreign exchange in Australia; the domestic currency depreciates.

iii) Increased demand for foreign exchange; Roseland's domestic currency depreciates.

iv) International capital outflow: demand for foreign currency outflow of foreign exchange, depreciation of domestic currency.

QUESTION NO. 3

i) The spot exchange rate changes from Rs 61/ 1$ to Rs 64/1$. It implies depreciation of Rupee and appreciation of Dollar. Exports become cheaper and more attractive to foreigners; imports will be discouraged as they become costlier to import.

ii) The spot exchange rate changes from Rs 66/ 1$ to Rs 63/1$. This means that Rupee has appreciated in value and dollar has depreciated. Exports become costlier and so demand for Indian exports may fall; imports become cheaper.

QUESTION NO. 4

i) The spot exchange rate between AUD and USD will not be affected as increased demand for foreign currency in each country will be matched by a proportionate increase in the supply of foreign exchange.

ii) Investors in Australia would demand more USD for making dollar denominated financial investments in the US. Supply of US dollars remaining the same, being in floating rate, AUD will depreciate and USD will appreciate.

iii) Large scale shift of Australian financial investments back to home due to political uncertainties in the US would result in large scale sale of financial assets and capital outflow from the US. This will lead to more inflow of US dollars to Australia and demand remaining the same, depreciation in the value of USD viz a viz AUD.

iv) Ban of exports to the US reduces USD inflows to Australia; demand for USD remaining the same, AUD may depreciate.

QUESTION NO. 5

i) **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.

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

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.

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