FOREIGN EXCHANGE RATE

Q1. What is foreign exchange rate?

Ans. It refers to the rate at which one currency is changed for the other.

EXAMPLE:- If dollar 1 can be exchanged for Rs. 60 when value of Rs. 2 will be Rs. 1 = 1/60$ = 0.167$.

Q2. Explain the concept of currency depreciation and currency appreciation.

Ans.

- **CURRENCY DEPRECIATION;-** It refers to decrease in the value of domestic currency in terms of foreign currency. It makes the domestic currency less valuable and more of it is required to buy the foreign currency.
  EXAMPLE:- Rs. Is said to be depreciating if price of $1 rise from Rs 55 to Rs. 60.
- ✓ **EFFECT OF DEPRECIATION;-** Depreciation of domestic currency means a fall in the price of domestic currency in terms of a foreign currency. It means with the same amount of $ more goods can be purchased from domestic currency i.e. exports from foreign country will be increase as they will become relatively cheaper.

- **CURRENCY APPRECIATION;-** It refers to the increase in the value of domestic currency in terms of foreign currency. The domestic currency become more valueable and less of it is required to buy foreign currency.
  EXAMPLE:- Indian rupee appreciate when price of $1 fall from Rs. 60 to Rs. 55.
- ✓ **EFFECT OF APPRECIATION:-** Appreciation of domestic currency means a rise in the price of domestic currency in terms of foreign currency now 1 Rs. Can be exchanged for more dollars i.e. with same amount of $ more goods can be purchased from foreign country. It leads to increase in imports from foreign country. As imports become relatively cheaper.

Q3. What are the types of foreign exchange rate?
Ans.

1. **FIXED EXCHANGE RATE SYSTEM:-** It refers to the system which exchange rate for currency is fixed by the government.

- It ensures stability in foreign trade and capital movement.
- To achieve stability government undertakes to buy foreign currency when the exchange rate become weaker and sell the foreign currency when the rate of exchange get stronger.
- For this government has to maintain large reserves of foreign currency to maintain the exchange rate at the level fixed by it.
- If the value of domestic currency is reduced by the government it will be called devaluation. It is said to occur when the exchange rate is increased by the government under fixed exchange rate system.
- If the value of domestic currency is increased by the government it be called revaluation.

2. **FLEXIBLE EXCHANGE RATE SYSTEM;-** It refers to a system in which exchange rate is determine by forces of demand and supply of different currencies in the foreign exchange market.

- The value of currency is allowed to fluctuate freely according to change in demand supply and foreign exchange.
- There is no official intervention in the foreign exchange market.
- Flexible exchange rate is also known as floating exchange rate, par rate of exchange or equilibrium rate of exchange.

3. **MANAGED FLOATING RATE SYSTEM;-** It refers to the system in which foreign exchange rate is determined by market forces and central bank influences the exchange rate through intervention in the foreign exchange market.

- It is the mixture of fixed exchange rate and flexible exchange rate.
- In this system central bank interments in the foreign exchange market to restrict the fluctuation in the exchange rate within the certain limits.
- This aim is to keep exchange rate closed to desired target values.
- Central bank maintains reserves of foreign exchange to ensure that deal. Exchange stays within the targeted value.
- It is also known as dirting floating.

Q4. For what reasons foreign exchange is demanded?
Ans.

1) **IMPORTS OF GOODS AND SERVICES;-** Foreign exchange is demanded to make the payment for imports of goods and services.
2) **TOURSIM;-** Foreign exchange is needed to meet expenditure incurred in foreign tours.
3) **UNILATERAL TRANSFERS SENT ABROAD;-** Foreign exchange is required for making unilateral transfers like sending gifts to other countries.
4) **PURCHASE OF ASSETS IN FOREIGN COUNTRIES;-** It is demanded to make payment for purchase of asset like land, shares in the foreign countries.
5) **SPECULATION;-** Demand for foreign exchange arises when people want to make games from appreciation of currency.

Q5. What are the sources of supply of foreign exchange?
Ans.

1. **EXPORT OF GOODS AND SERVICES;-** Supply of foreign exchange comes through export of goods and services.
2. **FOREIGN INVESTMENT;-** The amount which foreigners invest in the home country increases the supply of foreign exchange.
3. **REMITTANCE FROM ABROAD;-** Supply of foreign exchange increases in form of gifts and other remittances from abroad.
4. **SPECULATION;-** Supply of foreign exchange come from those who want to speculation on the value of foreign exchange.

Q6. How the exchange rate is determine.
Ans. The equilibrium exchange rate is determine at a level where demand for foreign exchange is equal to the supply of foreign exchange
Diagrams (2):-

1. Demand curve is downward sloping and supply curve is upward sloping both the curve intersect each other at point E. The equilibrium exchange rate is determine at OR. And equilibrium quantity is determined at OQ.
2. If the exchange rises to OR2 then demand for foreign exchange will fall to OQ2. And supply will rises to OQ1. It will be a situation of excess supply. As a result, exchange rate will fall till it again reaches the equilibrium level of OR.

3. If exchange rate falls to OR, then demand will rise to OQ1 and supply will fall to OQ2. It will be a case of excess demand, it will push up the exchange rate till it reaches OR.

Q7. When there will be change in exchange rate?
Ans. The equilibrium rate will be change if any change occur between demand and supply.

1. **CHANGE IN DEMAND;-** It may either increase in demand or decrease in demand.

- **INCREASE IN DEMAND;-**

- Increase in demand for foreign exchange will shift the demand curve towards the right from OD to D1D1
- There is an excess demand of OQ1 at original exchange rate of OR.
- As a result, the exchange rate rises to OR1. This show the value of domestic currency is depreciated.

- **DECREASE IN DEMAND;-**

- A decrease in demand will shift the demand curve toward left from DD to D2D2. It leads to a deficit demand of O1O2 at the original exchange rate of OR.
- As a result, the exchange rate will fall till it reaches OR2. This shows domestic currency has appreciated.

2. **CHANGE IN SUPPLY;-**

- **INCREASE IN SUPPLY;-**

- If supply of foreign exchange increases it will lead to a rightward shift in supply curve from SS to S1S1.
- Now at the original exchange rate of OR there is an excess supply of QQ1. As a result, the new exchange rate moves down to OR1 domestic currency is appreciated.

- **DECREASE IN SUPPLY;-**

- A decrease in supply will shift the supply curve from SS to S2S2.
- It leads to deficit supply of QQ2 at the original exchange rate of OR the exchange rate will increases till it reaches to OR2. The domestic currency is depreciated.

Q8. Define foreign exchange market and its functions.
Ans. Foreign exchange market is the market in which foreign currency is bought and sold.

- **FUNCTIONS OF FOREIGN EXCHANGE MARKET;-**

1. **TRANSFER FUNCTION;-** It transfers purchasing power between the countries involved in the transition. This function is performed through credit instrument like bill of foreign exchange bank drafts and telephonic transfer.
2. **CREDIT FUNCTION;-** It provide credit for foreign trade.
3. **HEDGING FUNCTION;-** When exporter and importer enter into an agreement to sell and buy goods on some future date at the current prices. And exchange rate it is called hedging. The purpose of hedging is to avoid losses that might be caused due to exchange rate variation in the future.

Q9. What are the kinds of foreign exchange market?
Ans.

1. **SPOT MARKET;-** It refers to the market in which the receipts and payments are made immediately. The rate of exchange which prevail in the spot market is termed as spot exchange rate.
2. **FORWARD MARKET;-** It refers to the market in which sale purchase of foreign currency is settle down a specified future date at a rate agreed upon today the exchange rate quoted in forward transaction is known as forward exchange.

FUTURE FOUNDATION INSTITUTE, BASANT AVENUE, MODERN TOWER, OPP. BCM SCHOOL, Adj. HI-CARE HOSPITAL, LUDHIANA. Contact: 7009341956. www.ffinstitute.in info@ffinstitute.in